USAID Microenterprise Development Briefs

A Compilation of Briefs Issued
From February 1995 Through October 1998

January 2001

Office of Microenterprise Development
Bureau for Economic Growth and Agricultural Development
US Agency for International Development

Note: Title page added to electronic version by
USAID Development Experience Clearinghouse

USAID Microenterprise Development Briefs

Note: Table of contents page added to electronic version by
USAID Development Experience Clearinghouse

USAID

Microenterprise Development Brief
Number 1 February, 1995

What Are Microenterprises and What Activities does the USAID Microenterprise Initiative Support?

This statement is intended to answer some of the questions frequently asked about USAID's Microenterprise Initiative.[1]

Microenterprise Characteristics

Microenterprises are very small, informally organized, non-agricultural businesses that often employ a third or more of the labor force in lower-income countries. Many microenterprises employ just one person, the owner-operator or "microentrepreneur". Some microenterprises include unpaid family workers, and others may have one or several hired employees. Although no single characteristic distinguishes microenterprises from small enterprises, USAID has adopted a threshold of ten employees, including the owner-operator and any family workers, as the upper bound for an enterprise to be considered "micro".

Another important characteristic of a microenterprise is the level of assets or income--both of the business and those working in it. USAID has targeted its Microenterprise Initiative at the businesses run by and employing the *poor*. While definitions of poverty differ from one country context to another, Missions should ensure that any microenterprise programs they support benefit the most disadvantaged members of the sector. When screening potential clients, instead of means testing, successful microenterprise programs tailor their services to be attractive to the poor. Poverty lending programs, for example, use very small loans to reach the poorest clients and are an important part of the Initiative. The USAID Administrator has pledged that one half of all financial support to microenterprises will go through poverty-lending programs or through the poverty-level portions of mixed programs. USAID has traditionally used a loan size of $300 as a reference point in defining poverty lending.

Goals and Principles

As primary goals, the Microenterprise Initiative seeks to help the poor increase their income and assets, raise their skills and productivity, and form organizations that facilitate their more effective participation in society. In so doing, programs receiving USAID funding incorporate the following principles: a commitment to significant outreach of services, a continued focus on women and the very poor, a striving for sustainability and financial self-sufficiency, an adherence to rigorous performance standards, a sharing of information on best practices, and a fostering of innovation in both programs and supportive policy change. Programs supported by Missions should be committed to financial viability and have a credible plan for attaining it. Before receiving funding, existing programs should also demonstrate their ability to maintain low levels of delinquency and default while charging cost-recovery interest rates on loans.

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[1]The notice is for information only and does not replace USAID's Policy Determination #17 (PD-17) on Microenterprise Development. PD-17 is currently being revised.

Ways to Implement Programs

In promoting microenterprise development, Missions are encouraged to form partnerships with non-governmental organizations, associations, credit unions, banks, cooperatives, or other local institutions. A number of institutional paths are possible. Similarly, programs may use a variety of mechanisms including village banking, peer group "solidarity" lending, innovative individual savings and credit programs, and experimental, cost-effective techniques in non-financial assistance. Non-financial assistance might involve technical and management training, advocacy, or the release of market and infrastructural constraints identified in subsector analyses. Interventions may also encompass support of an enabling environment for microenterprises through institutional and economic policy change such as improvements in the legal and regulatory framework or reforms in the financial sector.

Microenterprise programs may range from an exclusive focus on non-financial assistance to programs concentrating solely on micro-credit delivery. Non-financial programs, particularly those that involve training, tend to be expensive and in most cases will be unable to cover costs through fees for services. Missions should exercise caution in funding these kinds of activities. Such programs may need to experiment with new techniques to increase their efficiency in service delivery.

Missions may want to wean successful micro-credit programs from continued dependence on donors' funds by helping the institutions transform into licensed financial intermediaries able to borrow from commercial banks and mobilize deposits from the public. Once licensed, the newly created intermediaries have the potential to leverage donor investments by several times or more.

Activities Not Included

In designing new programs, Missions should be aware of what does not constitute microenterprise development. Enterprises owned and operated by middle- or high-income persons, such as professional partnerships or small consulting firms, are not eligible for support under the Microenterprise Initiative, regardless of their size. Congressional interest in microenterprise development has always centered on reaching the poorest entrepreneurs. Missions should, therefore, not label as microenterprise development any programs that do not specifically address the sector in ways described above. For example, general policy reforms or agricultural-crop lending may, in fact, indirectly benefit microenterprises, but should not be classified as microenterprise development programs. Some microenterprise programs may also provide support to small businesses, but should clearly distinguish the different enterprise categories when reporting to USAID/Washington and the Congress.

Questions?

If Missions have any questions concerning this statement or whether particular activities fit under the Initiative, please contact Elisabeth Rhyne, Director of the Office of Microenterprise Development (G/EG/MD).

Microenterprise Development Brief
Number 2 February, 1995

Is Informal Finance Desirable?

Q&A with Claudio Gonzalez-Vega, Ohio State University

Question: **What are the most prevalent forms of informal finance?**

Answer: 1) Suppliers of credit, 2) ROSCAs, 3) Moneylenders/pawnshop operators. The suppliers of credit are vendors who supply raw materials and inputs to microentrepreneurs and accept payment at a later date subject to agreed upon terms. In ROSCAs -- Rotating Savings and Credit Associations -- members contribute a regular amount each week or month, with group members taking turns receiving loans from the pool of funds. Moneylenders and pawnshop operators are typically individuals who use their personal resources to make loans, usually with high interest rates.

Question: **Are the services provided by informal lenders *valuable* for their clientele?**

Answer: Absolutely, YES. For this reason, one should oppose the repression of informal financial arrangements. Rather than view informal financiers as "evil", they should be seen as providers of valuable services demanded by their clientele. Without these informal arrangements, in many cases these services would not be provided at all and the welfare of the poor would be reduced.

Question: **Are the services provided by informal lenders *sufficient* from the perspective of their clientele?**

Answer: In many circumstances, the answer is NO. Informal lenders typically do not provide a sufficiently wide collection of services for which a demand exists (such as deposit facilities, money transfers, certain types of loans). Several of the "missing" services are those most demanded by the poor, particularly deposits. Moreover, informal financial services are either a part of a larger network of relationships (friends and relatives), which carry particular costs (difficult to measure), or are financially quite costly. It is not surprising, therefore, to observe a strong demand for semiformal and formal financial services that are cheaper and at the same time permanent and reliable.

Question: **Are informal financial services *efficient* from an economic perspective?**

Answer: Emphatically, NO. Informal financial arrangements are competitive only within small market segments, for financial transactions among agents who are in close proximity. Beyond the local boundaries, informal finance is "prohibitively expensive", and for this reason, one rarely sees informal financial mechanisms used by agents far away from each other. The information costs for screening and monitoring borrowers who are not in close proximity (same village, same occupation, same social group) are too high. In consequence, informal finance cannot contribute substantially to the reallocation of purchasing and investment ability in the economy, critical in order to increase the productivity of resources. This reallocation transfers command over resources from low to high-rate of return activities. Thus, informal finance is socially inefficient, and does not fully contribute significantly to economic growth. It leaves too many opportunities to improve resource allocation untouched.

Question: **Can informal financial transactions be complemented with formal financial intermediation?**

Answer: Potentially, YES. However, the task is not an easy one. The development of financial systems in many countries is an illustration of how this process takes place. Since the provision of formal financial systems is very costly, the process takes a long time and requires major improvements in infrastructure and institutions. To reach the poor requires, in addition, innovations in financial technology. Are these innovations possible? There are a few examples that suggest that this is the case under certain circumstances (which may not be present in every country). On the other hand, informal finance will never disappear, but it will occupy a shrinking niche in the market.

Question: **How would you summarize your position about informal financial intermediation?**

Answer: Valuable financial services are provided by informal arrangements. Economic development will require, however, the provision of additional formal financial services to replace or complement informal services. While understanding and appreciating the role of informal finance, the real challenge is to discover the appropriate combinations of technologies, organizations, and policies needed to develop national formal financial systems.

Sources:
- Keynote speech at the Conference "Financial Services and the Poor: U.S. and Developing Country Experiences," organized by USAID and the Brookings Institution in Washington, D.C. on September 28-30, 1994.
- Discussion on "DevFinance" network, internet.

Microenterprise Development Brief
Number 3 February, 1995

Principles of Financially Viable Lending To Poor Entrepreneurs

PRINCIPLE 1: OFFER SERVICES THAT FIT THE PREFERENCES OF POOR ENTREPRENEURS

- Give short-term loans. Short-term loans are compatible with enterprise outlay and income patterns. ACCION programs in Latin America and the Badan Kredit Kecamatan (BKK) in Indonesia typically lend for three-month terms; the Grameen Bank family of programs for one year.

- Give repeat loans. Full repayment of one loan brings access to another. Repeat lending allows credit to support financial management as a process, not an isolated event.

- Allow relatively unrestricted use. While most programs select customers with active enterprises (and thus cashflow for repayment), they recognize that clients may need to use funds for a mix of household or enterprise purposes, while emphasizing the latter.

- Give small loans. BKK and Grameen Bank loans are near $100, ACCION and BRI are in the $200-$1,000 range.

- Be customer-friendly. Locate outlets close to entrepreneurs; use extremely simple applications (often one page), and limit time between application and disbursement to a few days. Develop a public image approachable by poor people.

PRINCIPLE 2: STREAMLINE OPERATIONS TO REDUCE UNIT COSTS

- Develop highly streamlined operations, minimizing staff time per loan.

- Standardize the lending process. Applications should be very simple and should be approved on the basis of easily verifiable criteria, such as the existence of a going enterprise.

- Decentralize loan approval. Centralized approval adds time and costs while diminishing responsibility.

- Maintain inexpensive offices. BKK operates its village posts once a week from rooms in local government buildings, paying little or no overhead while reaching deep into rural areas.

- Select staff from local communities, including people with lower levels of education (and hence salaries) than staff in formal banking institutions.

PRINCIPLE 3: MOTIVATE CLIENTS TO REPAY LOANS

- Substitute for pre-loan project analysis and formal collateral by assuming that clients will be able to repay. Concentrate on providing motivation to repay.

- Joint liability groups, where a handful of borrowers guarantee each others' loans, are the most frequently used repayment motivator, employed by Grameen Bank and in slightly different form by ACCION affiliates. This technique has proved effective in many different countries and settings worldwide. Individual character lending can be effective where the social structure is cohesive, as has been demonstrated throughout Indonesia's array of credit programs.

- Use incentives such as guaranteeing access to loans, increasing loan sizes and preferential pricing for all who repay promptly.

- Institutions that successfully motivate repayments also develop staff competence and a public image that signal that they are serious about loan collection.

PRINCIPLE 4: CHARGE FULL-COST INTEREST RATES AND FEES

- The small loan sizes necessary to serve the poor still result in costs per loan which require interest rates that may be significantly higher than commercial bank rates (though significantly lower than informal sector rates).

- Poor entrepreneurs have shown willingness and ability to pay interest rates, higher than commercial bank rates, for services with attributes that fit their needs.

Source: Elisabeth Rhyne & Sharon L. Holt: World Bank Working Paper "Women in Finance and Enterprise Development," June 1994.

Microenterprise Development Brief
Number 4 February, 1995

KEY FINDINGS ON THE GROWTH AND DYNAMICS OF MICROENTERPRISES AND THE MICRO/SMALL ENTERPRISE (MSE) SECTOR?

Finding: Between 1980 and 1990, the MSE sector absorbed about one-third of the total increase in population of working age in all countries studied.

Implication: The MSE sector plays a critical role in absorbing new entrants into the labor force, particularly for women and those in rural areas. Therefore, support of the MSE sector is a desirable approach to combat unemployment.

Findings: In periods of economic growth, the MSE sector shows an expansion in existing businesses, leading to greater resilience and efficiency in the sector.

In periods of economic downturn, the MSE sector shows a higher rate of new business starts and fewer expansions of existing businesses. New starts generally appear in lower-return, easily-entered activities.

Implication: Because the state of the macroeconomy influences patterns of growth in the MSE sector, pursuit of a desirable macro-economic reform agenda can have positive effects on the MSE sector and its ability to contribute to economic growth.

Findings: The number of enterprises in the MSE sector grows on average 20 percent yearly, even in absence of specific policies to encourage new business starts.

Although, new business starts take place constantly, they experience high failure rates for the first three years.

In spite that new business starts are risky, they provide the majority of jobs in the sector.

Implication: Because new business starts are occurring without program interventions, avoid direct programming for this process. Instead, focus firm-level resources on enterprises that have passed the critical first phase and on strengthening the general business services infrastructure, such as market information and financial services.

Findings: Only one-third of enterprises add workers over their lifetime, and the majority that do grow add only one or two workers. However, in aggregate, this small growth provides 20 percent of the total jobs in the sector, and increases both the efficiency and likelihood of survival of growing enterprises.

Key constraints facing growing businesses are access to markets, access to inputs, and access to working capital, in that order.

The types of enterprises that have shown a better record of expansion are urban and male-owned. This may point to lower access to markets, inputs, or capital for women-owned or rural enterprises.

Implications: Continue expansion of financial services programming, particularly for rural areas.

Financial services programs should be complemented with programs to open markets or introduce cost-saving technologies, particularly in cases where demand for MSE products is not expanding.

Market-related interventions may be required to: (i) identify profitable market opportunities for MSEs, (ii) help on-going businesses access inputs and markets, and (iii) develop market linkages to facilitate business growth.

Source: GEMINI Draft ARP I Summary Paper, mimeo, Development Alternatives, Inc., September 1994.

Microenterprise Development Brief
Number 5 February, 1995

NON-FINANCIAL ASSISTANCE TO MICROENTREPRENEURS

Non-financial assistance is a concern for USAID's Microenterprise Initiative, because few microenterprise entrepreneurs list finance as their first priority. Microenterprises--growing the fastest and creating the most jobs--put finance lower in their priority list than do slower growing and static firms.

Prior to GEMINI, the bulk of work on non-financial assistance for small enterprise development concentrated on how different types of assistance, such as business planning support, entrepreneurial motivation and development, accounting training, help individual enterprises to grow and be more competitive. USAID's Microenterprise Stocktaking noted that, as one moves from servicing small enterprises to microenterprises, the prospects for such firm-intensive assistance being cost-effective decline precipitously. This is because the costs of providing professionally competent business services becomes exceedingly large relative to firm revenues.

INCREASING COST-EFFECTIVENESS IN FIRM-LEVEL ASSISTANCE

GEMINI examined how ongoing programs offering non-financial services were able to respond to opportunities and constraints facing microenterprises. GEMINI's action research in many different countries has found that:

- *Direct firm-level non-financial services can only be cost-effective if they are delivered on a large scale, and can use their delivery system to minimize transaction costs.*

- *A number of more indirect services, including technological innovation, larger-smaller firm linkages, and policy reform, may offer an alternative path to cost-effective microenterprise support--but how cost-effective these services are depends on how they are delivered.*

- *Concentrating on particular subsectors, chosen because they show strong market growth opportunities, can make it easier for a microenterprise support institution to identify successful strategies for negotiating both the above paths to cost-effective non-financial assistance.*

DELIVERING COST-EFFECTIVE FIRM-LEVEL ASSISTANCE BY PIGGYBACKING

Direct delivery of non-financial services to microenterprises is, in many ways, a Catch-22 situation. As long as one works closely enough with individual microenterprises to tailor services to their specific business problems, the costs of the service agent will always dwarf the returns to the served enterprise. On the other hand, if one generalizes and standardizes assistance packages, reducing firm-level contact time and cost, one tends to end up with services that have little immediate application for the individual entrepreneur. Therefore, trade-offs must be made between scaling up and developing services for which clients are willing to cover the costs of delivery.

Only a few institutions are getting around this dilemma by piggybacking. They use pre-existing networks of large numbers of microenterprises as a base for piggybacking new services. Two of the best examples of piggybacking are found in the work of the Bangladesh Rural Advancement Committee (BRAC) and ACCION affiliates such as ACTUAR Bogota.

BRAC began in 1972 as a relief and rehabilitation organization, working with refugees from Bangladesh's 1971 Liberation war. It developed health, education and legal support services in thousands of villages, along with a staff of over 11,000 full-time and 20,000 part-time workers. BRAC uses this network of thousands of village extension agents to provide non-financial services to microenterprises at a very low unit cost. When it develops a new training product, it can deliver that product to a large number of households rapidly, and at minimal cost, through activating its extension network. For example, BRAC noticed, through its other rural development activities, that poultry raising was one of the most important sources of supplemental income for thousands of Bangladesh's rural families. In the late 1970s, BRAC used 400 women from one of its better organized regions to develop a training program for improving poultry raising. Following this pilot development and testing, the training was disseminated rapidly through BRAC's wider Rural Development and Credit and Vulnerable Group Development programs, reaching 158,000 households in 10 years. An economic analysis conducted by the Government of Bangladesh and BRAC in 1991 showed that the returns to microenterprises were over 4 times the investment BRAC had made in its poultry program (and rearing training was only one component of this investment).

ACCION affiliates all require borrowers to undertake some training as a pre-condition for receiving loans. ACTUAR Bogota applies the same principles of efficiency and financial self-sufficiency it uses in its credit program to its training and technical assistance programs. It seeks to attain financial self-sufficiency in each major component of these programs, and prices its training services to reflect their real costs of delivery. All of ACTUAR's clients receive the required training, which enables considerable economies of scale to be obtained. At the same time, ACTUAR's knowledge of microenterprise training needs, gleaned from its credit officers, has permitted the development of a substantial elective training curriculum. Many clients, learning the benefits of training from their required courses, choose to pay for additional training and technical assistance services, which provides ACTUAR with further economies of scale.

WARNING: TO PIGGYBACK, ONE MUST HAVE A PIG

In both cases the institutions scaling up non-financial services are doing so on the back of a large, pre-existing client network. They lower transaction costs through building training and technical assistance services for a captive audience. Such large networks are not common. Where they exist, they have evolved through considerable investment, sometimes for microenterprise finance, sometimes for other social development programs. *So this pathway for developing non-financial services is an interesting, but limited one. Forthcoming GEMINI briefs will consider alternative non-financial assistance strategies for situations where piggybacking is not possible.*

Source: GEMINI's ARP 3 Research Working Document.

Microenterprise Development Brief
Number 6 June, 1995

Controlling Fraud in Microfinance Programs[1]

There is a potential for fraud in any business dealing, particularly those dealing with finance. Certain situations are clearly fraudulent: for borrowers, misstating, misrepresenting, or paying bribes to get a loan, and for employees, putting fictitious loans on the books, colluding with customers to approve bogus loans, sharing loan proceeds, and taking money from savings accounts for one's own use. Other actions, however, may be unethical but not criminal fraud--e.g. small unsolicited payments from customers to express their thanks for getting a loan. *Soliciting* such payments or larger "gifts" could constitute fraud.

In realistic terms, management should not aim at *eliminating* fraud. To attempt to do so would require such heavy control and supervision costs, and such restrictive procedures as to "straight jacket" the institution and undermine its profitability. A more reasonable objective aims at *preventing and controlling* fraud -- keeping fraud within tolerable bounds in terms of cost and risk to assets and reputation.

REDUCING THE LIKELIHOOD OF FRAUD

Three aspects of a business are crucial for successful fraud-control programs: (1) market pricing, (2) simplicity of operations, and (3) accountability and transparency. Ultimately, reducing the risk of fraud is a matter of good management, of creating a work environment that reduces the incentives for employees to commit fraud.

Market Pricing

Lending at an interest rate that approximates the market rate is probably the most important single step that a microfinance organization can take to reduce fraud. There are still many programs around the world that lend at below-market, subsidized rates. Below-market pricing will guarantee that two types of distortions occur. First, there will be distortions of who gets the credit. Large operations or well connected individuals will attempt to move in and get some of the cheap money, taking it away from the intended customers--the microentrepreneurs. Second, subsidized rates will invite direct bribes to the employees of the financial institution who make loan decisions. Artificially low rates invite schemes to use the loan funds for unintended purposes, including relending at higher rates. At below market rates, a loan officer can be paid a bribe and the borrower can still earn a profit. By moving from artificially low to market pricing, a lending institution can remove much of the potential fraud and corruption that could weaken its programs. This can occur even for loans for intended uses: At below market rates, the borrower can afford to pay a bribe to a loan officer. Market pricing sharply reduces the attractiveness of these behaviors.

Paying attractive salaries to employees, at least equal to their best alternative employment, also deters fraud. In some lending organizations, particularly those operated directly by governments, the salary scale is so low that an employee cannot adequately support a family on his or her salary.

[1] Based on a presentation by Richard Hook at an USAID-MD Office seminar on controlling fraud. Richard Hook is an independent consultant based in Denmark, Maine. He has worked extensively with microfinance programs.

This offers enormous temptations for bribery and other fraudulent means of supplementing low salaries. Attractive wages do not prevent fraud, but they do reduce it.

Simplicity

Another key feature is simplicity: in the number of activities at a lending point, in loan structure (interest rates and loan terms) and in administration. The more complex an organization, the more overlapping of roles and multiplicity of financial products offered, the more opportunities there are for fraud. Conversely, the simpler an organization, the more standardized the credit packages, the fewer opportunities for individual negotiation of terms--the fewer opportunities for fraud.

In lending procedures, a typical fraudulent scheme would be for the loan officer to take a bribe from a customer in exchange for arranging a "sweet deal" such as a low interest rate with a long time lag before repayment. Standardized loan terms with no negotiation of interest rates reduce the chance for this sort of fraud.

Accountability and Transparency

Transparency--the ability to see clearly what is happening at a lending point and to pinpoint responsibility for outcomes--starts with the accounting system. Decentralization of accounting to the level of the lending point is an excellent start. Ideally, each lending unit would be a separate profit center with its own balance sheet and profit and loss statement. This permits production of daily statements for managerial purposes, and simplifies the job of detecting unusual transactions or sudden changes that may indicate fraudulent activities. If there is a deterioration in repayment at one unit, possibly because of fraudulent loans made, the decentralized reporting makes the deterioration easier to spot than if the unit's loan totals are mixed with those of many others.

Small size of the unit in terms of staff and products offered also supports transparency as there is "nowhere to hide". Keeping the lending units on a cash rather than an accrual basis further simplifies the accounting procedures and makes it easier to pick up any deteriorations in performance that may indicate fraud.

As described below, preventing fraud must be an element in several phases of the lending process: originating loans, monitoring, supervising/auditing, and applying sanctions.

A key stage in controlling fraud occurs at loan origination, which should consist of a field visit to the customer's business, a character check, and involvement of at least two persons in the origination/approval process.

The field visit is essential to make sure that the loan request makes sense in terms of the present scale of the business, and to determine that stated assets actually exist. Most microentrepreneurs do not have formal financial statements. The credit officer's field visit allows the officer to put together rough estimates of assets, liabilities, earnings, and cash flow.

Character is the single most important consideration in micro or any other form of lending. Ascertaining a borrower's character is easily done in rural areas, where local government officials, village heads, or well regarded customers in the same village will have a good idea of the applicant's reliability. In urban areas, checking character is more difficult, but it is still necessary to make some appraisal through conversations with existing customers or neighborhood leaders.

It is *not* a good idea to have the person who makes the field visit also be the one who approves the loan. For example, the manager of the lending unit might meet the customer and discuss the credit request, the credit officer would then make a field visit, and the manager would use the field report to make the credit judgment. Involving two people in the decision reduces the opportunity for fraud, both on the part of the customer and by the lender's staff. Collusion is possible, but requiring the participation of two people helps keep the process honest.

Putting a limit on the loan authority of the local manager is also useful in reducing the risk of fraud, at least for larger loans, which carry a high money risk for the lender. For example, a cap might be placed at $1,000, with loans over that size requiring the added approval of the local manager's boss at a higher level, perhaps the branch manager. Loan limits should be reviewed regularly and adjusted up or down or removed as an officer demonstrates his or her ability and honesty through high repayment rates.

CATCHING AND COPING WITH FRAUD

Monitoring

Contact with the borrower during the life of the loan is important, so that the lender knows how the borrower is doing. With monthly loan payments, continuing contact is easy, and the manager can talk with the customer when the customer comes to make payments. If there is a long grace period before payments are due, the manager or credit officer should visit the customer soon after the loan is made to make sure that things are going as planned. Borrower contact is important so that the lender can get an early warning as to legitimate business problems or possible fraud.

Failure to make payments on time is the clearest danger signal, both for business problems and for fraud. The local lending unit must make regular detailed reports on delinquent loan payments. This report must go to the supervising level for close review and a bank employee should make a prompt visit to the delinquent borrower to identify the problem and work out a solution. If the employee's supervisor has any reason to suspect that there may be fraud involved, the visit should include a staff person from the supervising level.

Even when loan payments are made on time, there may be a problem of fraud with the loan, as in cases where one fraudulent loan is being repaid with the proceeds of another fraudulent loan. For this reason it is especially important to monitor pre-payment of loans. Usually, however, fraudulent lending will result in missed payments, so the close scrutiny of delinquencies is essential.

Loan loss reserves and writing off expected losses should be based on the passage of time rather than on a "judgment call." To control the risk that the local manager and the borrower have colluded to have a loan written off, a supervising manager must review all reserved or written-off losses. For the same reason, it is important to continue collection efforts on written-off loans and to consider the possibility of legal action or other forceful means of recovery.

Supervision/ Auditing

Adequate supervision and simple running audits of cash, new loans, and delinquencies are extremely important in controlling fraud. This supervision should combine receipt and careful review of regular reports from the local lending units, with regular visits to lending units, depositors and borrowers on an unannounced, spot-check basis.

All banks, and most microfinance organizations will have some form of internal auditing, i.e., a separate group of employees (auditors/accountants) who on short notice or unannounced, will visit lending offices to review and audit the records. If adequately staffed and trained, and if the visits are frequent (perhaps a minimum of twice per year), internal audits can be an important factor in fraud control. Often, internal audits are confined to reviewing the accounts and internal records and reports, and do not include direct field visits with customers. This is a limiting factor in their usefulness in detecting fraud at the microloan level.

Outside private accounting firms or government auditing agencies conduct external audits, typically on an annual basis. The level of aggregation in most external audits limits their efficacy for fraud detection and control in microlending. Organizations should not depend on external audits to protect themselves from fraud.

Applying Sanctions

What should a manager do when fraud is discovered in a microfinance organization? There are many possible reactions, from ignoring the infraction, through gentle rebuke, to transfer, demotion or firing, and finally to civil or criminal action against employee or debtor. The eventual response actually depends on a number of factors, including the local financial culture, the corporate culture of the lending organization, the civil and criminal codes, and the quality and responsiveness of the legal system. The small sums typically represented in individual microloans often make legal action prohibitively expensive, except where the lending organization wants to make a public statement or offer an example to others on the seriousness with which it views the offense. A swift and decisive response, sends a clear message that the finance program is serious about maintaining solvency and upholding the integrity of its program, which will have financial payoff in the long run.

When employees are evaluated and rewarded on the basis of portfolio performance, then loan officers with high default rates can be counseled, reprimanded, held back for promotion, or eventually fired without the need to determine and prove fraud.

Whatever actions are taken should be consistent and should send a clear and firm message that fraud is taken seriously and will not be tolerated. The practice in some countries of limiting sanctions to lateral transfers or withholding salary increases for a year or two is unfortunate since it reinforces the idea that fraud is not a serious matter.

Conclusion

The potential cost of a fraudulent action to an employee or customer of the lending organization is the probability of being caught, multiplied by the severity of the sanction. From the lending organization's viewpoint, prevention is preferable to discovery or applying sanctions, although all three should be present in any workable approach to fraud control.

United States Agency for International Development
Microenterprise Development Brief
Number 6-F February 1998

LE CONTROLE DE FRAUDE DANS LES SYSTEMES FINANCIERS DÉCENTRALISÉS (SFD) / LES INSTITUTIONS DE MICROFINANCE

Dans toute entreprise il y a toujours des possibilités de fraude, et particulièrement dans les institutions financières.

Certaines situations sont clairement frauduleuses: tels sont pour un emprunteur la fourniture de fausses informations, d'une fausse identitée ou le paiement de pôts de vin pour obtenir un prêt. Les situations du coté des employés sont, par exemple, l'enregistrement de prêts fictifs, la complicité avec les clients pour approuver des prêts non-conformes, le partage des intérêts d'un prêt ou le détournement de fonds de l'institution ou de l'argent des comptes d'épargne des fins personnelles. D'autres actes cependant peuvent être contraires de l'éthique du travail, mais ne sont pas nécessairement frauduleux, tels que de petits cadeaux ou paiements offerts librement par un client à un agent pour exprimer ses remerciements après avoir obtenu un prêt. La solicitation de tels paiements ou des cadeaux plus importants peuvent constituer un cas de fraude.

En toute réalité, la direction ne peut viser d'éliminer totalement la fraude. Cela exigerait un niveau de contrôle tellement lourd, des coûts de supervision si élevés, des procédures si restrictives qu'ils pourraient étrangler l'institution et affecter sa rentabilité. Un objectif plus raisonnable vise prévenir et de contrôler la fraude au niveau de l'institution financière, de savoir maintenir la fraude dans des limites tolérables en terme de coûts et de risques liés aux actifs et la réputation de l'institution.

COMMENT REDUIRE LA PROBABILITE DE FRAUDE

Trois éléments sont éssentiels pour qu'une institution contrôle efficacement la fraude:

1. La politique de taux et de coûts des services;
2. La simplicité de ses opérations; et
3. La transparence et la responsabilisation des employés.

En fin de compte, le contrôle de la fraude est une question de bonne gestion et de mise en place d'un environnement de travail réduisant les incitations aux détournements.

1. La Politique de Taux et de Coûts des Services

La fixation d'un taux d'intérêt proche du taux du marché est probablement la mesure la plus importante qu'un SFD puisse prendre pour réduire les possibilités de fraude. Il existe encore dans le monde des programmes qui continuent de prêter à des taux d'intérêts inférieurs aux taux du marché et qui restent subventionnés. Ces taux amènent assurément deux types de problèmes. Tout d'abord pour les bénéficiaires de crédit: les grandes entreprises ou les personnes bien placées tenteront de profiter de l'argent offert de un "bon prix" tout en privant la clientèle cible - les micro-entrepreneurs. En second lieu les taux subventionnés peuvent amener les employés des SFD impliqués dans le processus de crédit de réclamer des pôts-de-vin de leurs clients. Les taux artificiellement bas permettent aux programmes d'utiliser les fonds de crédit pour des objets non prévus au départ, allant jusqu'à eprêter à des taux plus élevés. Avec des taux d'intérêt inférieurs au taux du marché un agent de crédit peut se faire verser des subsides tout en permettant à l'emprunteur d'être gagnant. En passant des taux artificiellement bas à des taux comparables au marché, l'institution de microfinance parvient à diminuer considerablement les possibilités de fraude et de corruption qui pourraient affecter son programme.

En payant des salaires attractifs à ses employés, au moins égaux ceux offerts par des emplois comparables sur le marché, le SFD diminue également les détournements. Dans certaines institutions de crédit, particulièrement celles dirigées par les gouvernements, la grille de salaire est si basse que l'employé ne peut pas subvenir aux besoins de sa famille avec son salaire. Cela provoque des tentations énormes pour obtenir des subsides ou frauder pour compléter un salaire. Cependant, il faut reconnaitre que le niveau des salaires n'empêche pas la fraude, mais une politique salariale cohérente accompagnée de systèmes de contrôle interne adéquats peuvent reduire considerablement la tentation des employés de commettre des actes frauduleux.

2. La Simplicité des Operations

L'autre élément fondamental pour réduir les cas de détournements est la simplicité des opérations au sein des SFD: entre autres dans les agences la structure de prêt (taux d'intrêt, échéances) et l'administration. Plus une organisation est complexe, plus les tâches se superposent et plus les produits financiers offerts sont multiples, plus les possibilités de fraude augmentent. Au contraire, les institutions de microfinance peuvent diminuer considérablement le risque de fraude par une organisation plus simple, une offre de crédit plus standardisée et moins de négociation individuelle des conditions de prêts.

Dans les procédures de prêts, un cas typique de fraude pour un agent de credit est l'obtention d'un pôt-de-vin en échange d'un "bon arrangement" sur les termes d'un pret (taux d'intérêt préférentiel, différé exageré). La standardisation des termes et conditions de crédit sans négociation des aux d'intérêt réduit les possibilités pour ce type de fraude.

3. La Transparence et la Responsabilisation

La transparence, de savoir la capacité de voir clairement ce qui se passe au point d'obtention du crédit et d'identifier facilement la responsabilité des résultats, commence avec le système comptable du SFD. Une décentralisation de la comptabilité au niveau du point de vente est un bon départ. De façon idéale chaque agence devrait être un centre de profit séparéayant ses propres états financiers. Cela permet de l'agence de produire des rapports financiers quotidiens ou hebdomadaire, afin de faciliter la gestion et de simplifier les tâches de contrôle dans l'identification des transactions anormales ou des changements soudains qui peuvent indiquer des activités frauduleuses. S'il y a une déterioration du taux de remboursement dans une agence, du fait probable de prêts fictifs, la décentralisation des rapports au niveau local rend plus facile la détection de cette déterioration que si les prêts de l'agence sont agrégés avec de nombreuses autres agences.

La petite taille de l'agence locale en termes de personnel et de gamme de produits peut avoir un effet sur le niveau de la transparence de l'institution, en cela qu'il devient plus difficile de cacher les malversations. L'utilisation d'un système comptable de caisse plutôt qu'enregistrant les dépenses de leur engagement et les produits à recevoir simplifie les procédures et permet de repérer plus facilement une baisse de performance qui peut indiquer des cas de fraudes.

Comme indiqué ci-dessus, la prévention de la fraude doit être traitée aux différentes étapes du processus de crédit: montage des dossiers de prêts, suivi, audit et supervision, et enfin application des sanctions en cas de fraude.

Une étape clef dans le contrôle de fraude se situe au montage des dossiers de crédit et devrait consister en une visite sur le terrain au lieu de travail du client, une enquête de moralité du client, et l'implication d'au moins deux personnes dans la phase établissement-approbation des prêts. Une visite de terrain au lieu de travail du client est essentielle pour s'assurer que la demande de prêt corresponde à la taille de l'entreprise, et que les actifs cités par le client dans sa demande existent bien. La plupart des micro-entrepreneurs ne peuvent pas fournir d'états financiers de leurs activités. Donc, la visite de terrain permet de l'agent de crédit de préparer un bilan estimatif (actif et passif), un compte de résultat et d'évaluer les flux de trésorerie.

La moralité de l'entrepreneur est la consideration la plus importante dans l'octroi des micro-crédits. L'évaluation de la moralité de l'entrepreneur est souvent plus facile en zone rurale où les élus locaux, les Chefs de village, les Conseils de Sages ou les anciens clients bien connus dans le village auront une bonne idée de la confiance à placer dans le demandeur de prêt. Elle est souvent plus difficile à déterminer en zone urbaine mais doit toujours être recherchée au travers de conversations avec des clients existants et des personnes influentes habitant dans le voisinage des candidats au crédit.

Une institution financière est exposée aux risques de fraude si la personne qui fait la visite de terrain est aussi celle qui approuve le prêt. Par exemple, le Chef d'agence peut rencontrer le client et discuter la demande de prêt, l'agent de crédit fait la visite de terrain et le Chef d'agence utilise le rapport de visite pour fonder sa décision. La complicitée est toujours possible, mais la séparation des tâches rend le processus de crédit plus transparent.

Limiter le pouvoir du chef d'agence dans l'approbation des prêts peut aussi réduire le risque de fraude, au moins pour les prêts importants, qui présentent un risque monétaire plus élevé pour l'institution. Par exemple un plafond peut être déterminé de $1000, au delà duquel un niveau de décision supérieur au chef d'agence locale est obligatoire (i.e., responsable d'un groupe d'agences). Les pouvoirs devraient être revus réguliè rement et ajustés par rapport de la performance du Chef d'agence en termes du taux de remboursement des prets.

LA DETECTION ET LES MESURES A PRENDRE EN CAS DE FRAUDE

1. Le Suivi

Le contact avec l'emprunteur pendant la durée du prêt est essentiel pour savoir comment vont ses activités. Lors de paiements mensuels ou plus fréquement, un contact permanent est facile; l'agent de crédit et le Chef d'agence peuvent parler avec le client au moment des remboursements. S'il y a un long différé de paiement avant que les remboursements ne commencent, l'agent de crédit (ou le gérant) doit faire une visite au lieu de travail de l'emprunteur suffisamment tôt pour s'assurer que tout se passe comme prévu. Ce type de contact avec l'emprunteur est nécessaire pour permettre au SFD d'identifier des problèmes des clients et de détecter des signes de fraude. Les retards de remboursement sont souvent les indicateurs de danger les plus clairs tant des problèmes de l'entreprise que des risques de fraude. L'agence locale de crédit doit préparer régulièrement des rapports détaillés sur les prêts en retard. Ces rapports doivent être adressés au superviseur pour revue. En plus, un agent doit rendre visite au lieu de travail de chaque client en retard pour identifier le problème et travailler ensemble avec le client pour trouver une solution. Si le superviseur a des raisons de suspecter un cas de fraude, un membre du personnel de supervision doit accompagner l'agent pendant la visite de terrain.

Même si les prêts sont remboursés à temps, il peut exister des cas de fraude liés au crédit. Par exemple, dans le cas où le rembours ement d'un prêt fictif est remboursé par un autre prêt fictif. Pour cette raison, il est très important de suivre de près les remboursements par anticipation. Dans la plupart des cas, les prêts frauduleux se terminent toujours par des retards de remboursement et par conséquent une analyse fine des prêts en retard est essentielle. Le provisionnement des prêts douteux et l'abandon de créances irrecouvrables doivent être basés sur une notion de durée et non sur un arbitrage subjectif du personnel. Pour limiter le risque que le chef d'agence et l'emprunteur s'"arrangent" pour passer un prêt en perte, le superviseur du gérant doit faire une revue régulière des provisions et des créances irrecouvrables abandonnées. Pour cette même raison, il est important de continuer les efforts de recouvrement des prêts passés en pertes et d'envisager des actions judiciaires ou d'autres moyens de pression pour recouvrer ces prêts.

2. La Supervision et les Audits Internes et Externes

Une supervision adéquate et des audits simples des encaisses, des nouveaux prêts et des prêts en souffrance sont extrêmement importants pour le contrôle de la fraude dans une institution de microfinance. Ce type de supervision doit être basé sur la reception et la revue soigneuse des rapports venant des agences de crédit, renforcées par des visites régulières et inopinées aux agences, ainsi que chez les emprunteurs et épargnants.

Les banques, et la plupart des institutions de microfinance ont dans leurs structures un service d'audit interne ou d'inspection comprenant un certain nombre de cadres (auditeurs/comptables) qui font des visites surprises, ou sur demande de la Direction pour vérifier la comptabilité et les dossiers des clients. Si ce service est dôté d'un personnel adéquat et bien formé, et si les visites sont fréquentes (au minimum deux fois par an), les audits internes peuvent contribuer largement au contrôle des activités frauduleuses au sein de l'institution. Souvent les audits internes sont limités à une révision des comptes et des rapports financiers et n'incluent pas de visites de terrain des clients. C'est un facteur limitant leur utilité pour la détection des détournements en matière de microcrédit.

Des cabinets d'audit externe ou des organes de régulation officiels font souvent des audits financiers, en général annuellement. Le niveau d'aggrégation de la plupart de ces audits externes limiteleur efficacitéen ce qui concerne la détection et le contrôle de la fraude dans less institutions de microfinance. C'est pourquoi, les SFD ne doivent pas compter exclusivement sur les audits externes pour se protéger contre les risques de détournement.

3. L'Application des Sanctions en Cas de Fraude

Qu'est-ce que la Direction doit faire quand une fraude est découverte dans une institution de microfinance? À ce niveau plusieurs réactions sont possibles:

- La Direction peut ignorer l'infraction, ce qui n'est pas conseillé;
- La Direction peut donner un avertissement ou une blâme à l'employé, ou prendre des sanctions pécunières contre lui là où cela est permis par le code de travail;
- La Direction peut déplacer ou licencier l'employé; ou
- La Direction peut initier des actions judiciaires contre l'employé ou le client en question.

La réponse appropriée à cette question dépendra plus de la prise en compte d'un certain nombre de facteurs comme la culture financière locale,l'esprit maison ou la culture interne de l'institution de microfinance en question, les codes civil et pénal du pays, et la qualité et l'efficacité du système judiciaire du pays. Les petits montants des micro-crédits rendent souvent une action juridique excessivement coûteuse en cas de fraude, sauf dans le cas où l'institution de microfinance veut communiquer un message très clair et présenter un exemple de ses clients et à ses employés sur la gravité qu'elle accorde au cas. Une réponse rapide et décisive peut renforcer le message de l'institution de microfinance concernant la sauvegarde de ses actifs et de son image.

Quand les employés impliqués directement dans les activités de crédit sont évalués et recompensés sur la base de la performance du portefeui lle de prêts, un agent de crédit enregistrant un taux de défaillance très élevé peut être conseillé, recevoir une avertissement, être retrogradé ou éventuellement licencié sans que l'institution soit obligée de détecter et prouver l'existance de fraude au niveau de l'agent. Quel que soit la décision prise par la Direction, elle doit être de poids et renforcer l'idée que la fraude ne sera pas tolérée. La pratique dans certains pays de limiter les actions de un déplacement de l'employé au sein de la structure ou de lui refuser un avancement pour une période d'un ou deux ans est malheureuse parceque ce type de décision de la part de la Direction renforce l'idée que la fraude n'est pas quelque chose de grave!

CONCLUSION

Pour une institution de microcrédit, le coût latent d'un acte frauduleux d'un client ou d'un employé équivaut de la probabilité d'être attrapé multipliée par le degré de sévérité de la sanction prise contre la fraude.

Du point de vue de l'institution, la prévention est toujours préferable de la découverte des faits ou de l'application de sanctions. Cependant, la combinaison de ces trois aspects doit être présente pour une approche efficace du contrôle de la fraude.

La Source: Richard Hook. Microenterprise Development Brief Number 6, June 1995. Nos remerciements vont à Richard Kimball, Guinea Rural Enterprise Development Project / Programme Intégré pour le Développement de l'Entreprise (PRIDE) et à Gilles Galludec, Consultative Group to Assist the Poorest (CGAP) pour la traduction en Français.

USAID Office of Microenterprise Development
Washington, DC 20523-0221 USA
T:202-712-0030 F:202-216-3593
http://www.mip.org

United States Agency for International Development
Microenterprise Development Brief
Number 7 July 1995

MICROnet-l: An Electronic Mailing List for Microenterprise Issues

MICROnet-l is an unmoderated Internet electronic-mail list for discussion of specific problems and their programmatic and technical solutions that relate to microenterprises and their development.

MICROnet-l is sponsored by the Office of Microenterprise Development in the Economic Growth Center of the Global Bureau. Participation is limited at present to USAID (anyone with a USAID.GOV internet address), although if the network is successful it may be expanded in the future.

We hope that this list will allow USAID staff to exchange information efficiently about experiences in microenterprise development, and that the network will become an important tool for the subscribers in making connections.

We encourage all interested participants to contribute any perspective, view, or question that they think is appropriate. This forum needs every participant to contribute freely and frankly to help us understand the issues and technical challenges.

Please note that even though the network is internal to USAID, participants should be careful to avoid placing confidential or source selection information on the network. G/EG/MD plans to use the network as a distribution channel for information such as abstracts of new reports, summaries of seminars, and news items. We invite subscribers to use the network in the same way and to take an active role in initiating dialogue. Anyone interested in acting as facilitator/provocateur for a couple of weeks should contact Barrett Ware in G/EG/MD. Barrett is also the contact for any technical problems you may have.

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Microenterprise Development Brief
Number 8 July 1995

USAID Microenterprise Development Office

Services and Activities

In June 1994, USAID launched the Microenterprise Initiative. The Initiative is a set of policies, strategies and specific actions designed to make microenterprise a prominent part of USAID's economic growth strategy. USAID's Economic Growth Strategy Statement emphasizes "broad-based and sustained economic growth that brings poor, disadvantaged and marginalized groups into the mainstream of an expanding economy". In most developing countries microenterprises are a major path through which poor people, especially women, participate in the economy. As an important source of income and employment, microenterprises often employ a third or more of the labor force, especially where the formal sector is small.

The Microenterprise Development Office (G/EG/MD) was created to be the main hub of technical resources, and the management unit for the central funding mechanisms, called for in the Microenterprise Initiative. The office addresses the fundamental development goals embraced by the Microenterprise Initiative, at three levels:

- To assist poor people to increase their income and assets, thereby gaining the basis to improve their welfare.

- To increase the skill and productivity base of the economy, so that the capacity of the economy to grow is enhanced.

- To facilitate the development of local organizations serving the microenterprise sector, organizations which become, in effect, institutions of economic democracy.

Among the specific aims sought are: achieving greater outreach and significant scale by microfinance organizations; financial viability of financial services; cost effectiveness of non-financial services; local institutional development and long-term viability; reaching women and the very poor; and, performance and impact information that focuses on results.

The office manages six major activities, as follows:

1. **Implementation Grant Program (IGP)**. The purpose is to expand microenterprise service provision by increasing the financial viability of local institutions that provide financial services -- credit and savings -- and the cost effectiveness of those institutions that provide other inputs. The IGP is a competitively run grant program open to US PVOs and other experienced organizations. Cooperative agreements are signed in response to a Request for Applications.

2. **The PRIME Fund** is a Mission co-financed grant fund designed to improve the quality and increase the quantity of Mission support to microenterprise programs. It supports high quality microenterprise programs put forward by USAID missions. Funds are transferred to missions through the OYB.

3. **Microenterprise Best Practice (MBP)**, a training, research and information exchange component, is designed to expand the knowledge base of the microenterprise field and to improve the design and implementation of USAID-supported projects. MBP consists of a core agenda and a sub-grant facility to encourage "best practices" in the field. MBP will be one contract involving a consortium of technical consultants and practitioners.

4. **MicroServe**'s purpose is to increase the capacity of USAID Missions, Agency personnel and implementing organizations to undertake microenterprise programs. MicroServe provides short-term technical assistance to field missions and implementing organizations. There will be two contracts involving consortia of technical consultants, academics and practitioners.

5. **Microenterprise Impact** will contribute to USAID's understanding of how microenterprise services improve the business and welfare of microentrepreneurs, households and communities over time. This research and technical assistance program will be one contract involving a consortium of technical consultants, academics and PVO/NGO representatives.

6. **Linkage Activities** are designed to foster greater involvement of other entities in microenterprise development by making microenterprise a more important part of USAID's economic growth strategy and increasing donor coordination. These activities include an agreement with the Peace Corps to expand microenterprise work, support to inter-donor activities, such as the Consultative Group to Assist the Poorest, and collaboration with other USAID offices focused on related topics to leverage their investige the role of microenterprise development in their substantive domains.

7. **Staff Support** to missions by G/EG/MD staff is available for any aspect of microenterprise development, through electronic or face-to-face consultations, and field visits. In addition, the office supports MICROnet-L, an unmoderated USAID electronic-mail list for a discussion of microenterprise issues. Participation is limited at present to USAID (anyone with a USAID.GOV internet address), although if the network is successful it may be expanded in the future. To send a message/queries to the entire list, address your message to:internet[MICROnet-l@info.usaid.gov]. And to subscribe, send a message to: internet[listproc@info.usaid.gov]. The message should read: SUBSCRIBE MICROnet-L <Your Name>

Bureau for Global Programs, Economic Growth Center, Office of Microenterprise Development
1300 Pennsylvania Avenue, NW, Washington, DC 20523 Tel.: (202) 712-5967, Fax: (202) 216-3593

USAID

Microenterprise Development Brief
Number 9 June, 1995

ASSESSING THE IMPACTS OF MICROENTERPRISE INTERVENTIONS A FRAMEWORK FOR ANALYSIS

A recent USAID-supported report, "Assessing the Impacts of Microenterprise Interventions, A Framework for Analysis," presents a preliminary framework for evaluating how microenterprise interventions contribute to household security, enterprise stability and growth, individual well-being, and the economic development of communities.

The approach departs from convention: it starts with the household. It recognizes that decisions about microenterprises can be understood more clearly when considered in relation to the overall household economy. Not only do microenterprises belong to a larger portfolio of household economic activities, but they also depend to varying degrees on their households for capital, labor, and other inputs. Furthermore, income generated by microenterprises is used for family consumption and investment.

The framework permits the analysis of four intervention strategies: financial services; "social intermediation" which helps marginalized clients connect to more formal financial institutions through village banking, solidarity groups, and other organizational forms; economic policy, regulatory reforms, or other subsector interventions; and technical and management assistance such as training and business advisory services.

MICROENTERPRISES, HOUSEHOLD SECURITY, AND ECONOMIC GROWTH

The conceptual approach links microenterprises to their broader environment by considering the relationship between microenterprises,household economic security, and economic growth. Microenterprises generate income for poor people and their households. This income leads to enterprise development when it is reinvested in the microenterprise or other household enterprises and to the household economy when used for household consumption or for investments in assets, including savings, real property, physical assets, and human capital.

Microenterprises also contribute to economic growth:

- o at the household level, by generating net increases in household income, asset accumulation, labor productivity, and improvements in economic security -- a launching pad for further growth;
- o at the enterprise level, by increasing income, employment, assets, and the volume of production;
- o at the individual level, by improving an individual's control and leverage over resources, often resulting in greater economic participation, especially by women;
- o at the community level, by expanding income flowing through the community, and stimulating linkages to otherlocal and regional enterprises.

THE IMPACT OF MICROENTERPRISE INTERVENTIONS

The framework identifies impacts, domains and markers of impact, as represented in the table below.

While each marker can stand alone as an indicator of impact, in combination they indicate more clearly the depth of the movement. Markers of change suggest not only whether but <u>how</u> microenterprise interventions expand options for poor women and men in relation to the broader development goals of poverty alleviation and economic growth.

IMPACT PATHS	DOMAINS OF IMPACT	MARKERS
Increase Household Economic Security	Income, expenditures on household consumption; assets.	Sources of income; debt, consumption expenditures; savings, productive investments, real property, human capital.
Improved Enterprise Viability, Stability and Growth.	Resource base; production processes; management; markets; financial performance.	Capital, labor, assets, inputs; outputs, technology; changes in management practices; size, diversity and stability of markets; financial performance, including income.
Improved Individual Well Being.	Control of resources; leverage in household decision-making; community participation.	Time, labor, income assets; decisions over consumption production, assets; social networks, civic organizations;
Increase Community Development	Income and employment changes; forward and backward changes; social networks, civic organizations.	Net income and employment changes; forward and backward changes; social networks, civic organizations.

The final component of the preliminary framework describes contextual factors that affect the potential for impacts to occur. Preliminary examples include: household characteristics such as dependency ratios; enterprise characteristics such as the subsector of operation; client characteristics such as gender or ethnicity; economic factors such as inflation, price distortions, or disruptions due to crisis; and the policy environment as it affects factor and product markets, location decisions, or competition.

UNDERTAKING IMPACT ASSESSMENTS: NEXT STEPS

The report recognizes a need for impact studies that are conceptually grounded, yet methodologically practical. The projects studied should be mature so that impacts are discernible. Such studies should address two objectives: first, to determine the difference that microenterprise interventions make to the client, his or her household, the enterprises, and the community; and, second, to generate information useful for improving the design and implementation of microenterprise programs and projects. The studies should be rigorous, and should use comparison groups. They should be longitudinal, spanning at least three to four years, and large survey data should be complemented by data collected several times from a selected subsample or from case studies.

The report identifies a need for operations research to further develop and refine valid, reliable, and feasible measures of impact; to test proxy measures of impact; and to study relationships between key impact variables that are not adequately understood. The results of the operations research could be used to develop and refine hypotheses and indicators prior to their inclusion in larger impact assessments.

CONCLUSIONS

This preliminary framework is intended to raise issues, establish parameters, and identify key impact variables to guide USAID and its partners in designing future impact assessments. It is not a final work, but a first step in setting forth a broader approach for evaluating the impacts of microenterprise interventions.

This brief summaries the report, "Assessing the Impacts of Microenterprise Interventions, Towards a Broader Approach", by Catherine Neill, Jennefer Sebstad, Carolyn Barnes and Gregory Chen, Management Systems International, March 1995. To obtain a copy of the report please contact Bureau of Global Programs, Economic Growth Center, Office of Microenterprise Development, USAID, SA-2, Room 300, Washington D.C. 20523. Tel :(202) 663-2360, Fax: (202) 663-2708.

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United States Agency for International Development

Microenterprise Development Brief
Number 10 August 1995

Consultative Group to Assist the Poorest (CGAP)

Background
The Consultative Group to Assist the Poorest was established on March 21, 1995 as a multi-donor effort to support microfinance. The project is in furtherance of the effort by the World Bank, the Governments of the United States, France, the Netherlands and Canada, and the International Fund for Agricultural Development (IFAD) to address the provision of assistance to the poorest, initially through a micro-finance program.

The CGAP program is aimed at the poor who can benefit from improved access to financial and related services, with an emphasis on reaching the poorest of this group. Its aim is to enable very poor women and men to become progressively more productive, with the expectation that some participants would eventually move on to use formal banking services.

The CGAP will provide grants and/or loans to legally registered institutions that provide financial and related services to the poor, provided that these institutions meet the agreed upon eligibility criteria. Emphasis will be given to micro-finance institutions that deliver credit and/or savings services to the very poor on a financially sustainable bases or that are capable of becoming financially sustainable.

The CGAP will: (i) expand the level of resources reaching the poorest of the economically active poor, initially through supporting the development of sound micro-finance institutions that meet eligibility criteria approved by the consultative group; (ii) improve donor coordination for systematic financing of such programs; and (iii) provide governments and donors with a vehicle for structured learning and dissemination of best practices for delivering financial services to the poor. Through these measures, CGAP will help improve access of low-income groups to financial services by identifying institutional and policy deficiencies for remedial action.

CGAP will play a catalytic role in achieving these objectives through a three-pronged approach : (i) mainstreaming micro-finance best practice into donor policy and operational support; (ii) disseminating best practice to governments and participating institutions; and (iii) funding programs/institutions to help build sustainable financial service delivery capacity.

The World Bank has pledged $30 million in new funding for CGAP, and member donors may pledge additional amounts into that pool of funds. Most member donor participation will take place through the approximately $US170 million of their own programs that donors have pledged as: (a) part of the learning agenda, or (b) available for joint or parallel financing.

Activities for Year One
The first meeting to constitute the Consultative Group was held in Washington DC in June of 1995. Proposed CGAP Work Program for the first year of operation is described below:

Program development. Program development will be the first task of the Consultative Group, and will include activities such as recruiting staff, developing operating procedures, setting eligibility criteria and performance standards for participating institutions, developing a work program and budget;

Support for Microfinance Programs. Once procedures are established proposals will be solicited through the sponsorship of CGAP member donors. Proposals will be screened by the secretariat and an Investment Committee. The first tranche of grant disbursements will take place in early to mid-1996.

Research and Information Dissemination. The CG will convene an expert panel to shape research agenda. It will establish and maintain vehicles for information flow (newsletters, short notes, on-line bulletins and conferences), and support various dissemination activities, including monthly meetings, regional seminars, and an annual CGAP conference.

Eligibility Criteria for the Participating Institutions (PIs)
A variety of financial institutions in developing countries may be eligible for financing from the micro-finance program, including NGOs, credit unions, cooperatives, and banks. In general, the objective is to reach established institutional programs that are ready for expansion, while some funds will be targeted for promising start-ups as well. Eligible institutions will have: a focus on the very poor; a proven track record, including excellent loan repayments; sound economic practices that will lead to operation on a sustainable basis; the ability to put up matching funds (preferably not from other donors); a capacity to absorb and use well additional funds; a viable business plan that shows movement toward full cost-recovery and full financial sustainability; and, legal registration in countries of operation.

US Participation in CGAP
The US Government has been an enthusiastic supporter of CGAP. USAID participates directly as a member of the Consultative Group. USAID will bring up to $US 70 million of its own microenterprise finance projects into the CGAP program by pledging those projects to be part of the CGAP learning agenda. USAID will retain management of its programs that are placed under the CGAP umbrella.

email: CPROJECT@WORLDBANK.ORG

Source: A Policy Framework for The Consultative Group to Assist the Poorest (CGAP): A Micro-Finance Program. 1995.

Microenterprise Development Brief
Number 11 September 1995

Small and Microenterprise Finance: Guiding Principles for Selecting and Supporting Intermediaries[1]

The purpose of these principles is to establish common standards for donor agencies to apply in supporting broader access to financial services for micro and small enterprises.[2] Such enterprises have historically lacked access to the formal financial system, but the growing success of many institutions provides confidence that access can be provided sustainably in many settings. It has now become possible to identify and agree upon the basic principles that support successful micro-level finance, so that donors can work in concert to ensure that lessons of success are translated to the institutions they support.

The framework for donor support to micro and small enterprise finance centers on two equally important and complementary objectives. First, **outreach** embodies the aim of expanding access to increasing numbers of low-income clients. Second, **sustainability** provides the means to expand and maintain outreach. These concepts underpin the guiding principles described here.

Different types of micro and small enterprise clients have different characteristics and demand different services. Hence it is desirable to encourage a range of institutions that use specialized methods to serve their particular market niches. These can include commercial and development banks, credit unions, mutual or community banks, non-governmental organizations (NGOs), finance companies, cooperatives, savings and credit associations, and other specialized intermediaries. At the same time, however, this document is based on the premise that fundamental principles of finance apply widely and must be observed by all institutions if they are to succeed. Moreover, donors must design their support mechanisms in ways that are consistent with best international practices and long-run development of a sound financial system.

This statement of guiding principles first identifies characteristics donors should seek in selecting institutions to support. It then describes appropriate forms of donor support. An annex lists reporting standards on outreach and financial performance.

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[1] This document is a joint product of the Donor's Working Group on Financial Sector Development and the Committee of Donor Agencies for Small Enterprise Development. It was inspired by and is largely consistent with the recommended standards for support set out by a UN expert group of leading small and microenterprise practitioners convened by Women's World Banking in January 1994. The donor committees adopted the principles in their current form in June 1995, following consultations with key donor agencies involved in small and microfinance. This document is intended for use by project officers in donor and implementing organizations, managers, and policy makers.

[2] Included in the term micro and small enterprises are a wide range of enterprises (industry, transport, commerce, services, agriculture, etc.) ranging in size from part time, seasonal activities of a single person to small, formal enterprises employing several non-family members.

I. Institutional Performance Standards and Plans

Intermediaries seeking support should be able to demonstrate the following characteristics, either in current operations or through credible plans underpinned by concrete measures. Since institutions are at different stages of development, it may be appropriate in some cases to adopt modified standards for limited support to new or transforming institutions.

A. Institutional Strengths

1. **Institutional culture, structures, capacities, and operating systems** that can support sustained service delivery to a significant and growing number of low income clients. Requirements include a sound governing structure, freedom from political interference, good fit to local context, competent and stable staff, a strong business plan for expansion and sustainability, and mission and vision which create a sense of purpose, ownership, and accountability.

2. **Accurate management information systems** that are actively used to make decisions, motivate performance and provide accountability for funds. Such systems are essential for effective and efficient management.

3. **Operations that manage small transactions efficiently**, with high productivity, as measured by variables such as loans per staff and operating costs as a percentage of average annual portfolio (while maintaining portfolio soundness).

4. **Meaningful reporting standards**. Transparent financial reporting that conforms to international standards and allows prospective funders to evaluate performance adequately. At a minimum, the raw data listed in the Annex should be reported, and institutions should regularly monitor financial condition using appropriate financial ratios derived from such data.

B. Quality of Services and Outreach

1. **Focus on the poor**. Evidence of service to low-income clients, women and men, especially clients lacking access to other financial institutions. The focus need not be exclusive, as mainstream institutions such as banks are encouraged to become providers, but it must entail a distinct commitment to reaching the poor.

2. **Client-appropriate lending.** For example, for micro-level clients, institutions should feature quick, simple and convenient access to small, short-term loans, often short-term, that are renewed or increased based on excellent repayments. Use of collateral substitutes (e.g., peer guarantees or repayment incentives) or alternative forms of collateral to motivate repayment. Emphasis on character-based lending for smaller loans, with simple cashflow and project appraisal for larger and longer term loans.

3. **Savings services.** Offering savings mobilization services, where legally possible and economically feasible, that facilitate small deposits, convenient collections, safety, and ready access to funds -- either independently or with another institution.

4. **Growth of Outreach**. Making significant progress in expanding client reach and market

penetration, demonstrating both strong client response to services offered and competence in service delivery management.

C. Financial Performance

1. **Appropriate pricing policies**. Offering loans at rates sufficient eventually to cover the full costs of efficient lending on a sustainable basis (after a reasonable start-up period), recognizing that poor entrepreneurs are able and willing to pay what it costs an efficient lender to provide sustainable financial services. Interest charges by the retail unit should be set to cover the costs of capital (at the opportunity cost, including inflation), administration, loan losses and a minimum return on equity.[3]

2. **Portfolio quality.** Maintaining a portfolio with arrears low enough that late payments and defaults do not threaten the ongoing viability of the institution. For example, organizations with loans in arrears over 30 days below 10 percent of loans outstanding and annual loan losses under 4 percent of loans outstanding satisfy this condition.

3. **Self-sufficiency**. Steadily reducing dependence on subsidies in order to move toward financial self-sufficiency. Achieving operational efficiency [defined as covering all administrative costs and loan losses with client revenues] within a reasonable time period, given local conditions. International experience shows that successful intermediaries have achieved operational efficiency in three to seven years, and financial self-sufficiency [defined as covering all adminstrative costs, loan losses, and financing costs at non-subsidized rates from client revenues] within five to ten years.

4. **Movement toward financial independence**. Building a solid and growing funding base with clear business plans, backed by operational capacities, that lead to mobilization of commercial funds from depositors and the financial system, and eventually to full independence from donor support.

Financial performance standards apply only to activities that are an integral part of providing financial services. If programs also provide non-financial services, such as business advisory services, health, or education they must account for such services separately from financial services. Standards for financial self-sufficiency do not apply to such services, and defining appropriate standards for non-financial services is beyond the scope of this document.

[3] It should be understood that costs of non-financial assistance provided to entrepreneurs may continue to receive subsidies. However, it is crucial that these costs be separated from the costs of lending operations, so that the financial viability of lending operations can be assessed.

II. Strategies for Donor Support

Funding based on large, ongoing subsidies with a charity rationale has failed. Such programs have drained resources without becoming sustainable, and have contributed to the mistaken notion that the poor are unbankable. Funders should provide financial and other support in such a way to ensure the quality of services provided and the widest outreach, as well as to foster the movement to scale, financial self-sufficiency, and independence from donor support, taking into account the particular characteristics of different types of institutions. Donors should ensure that institutions, in their effort to become sustainable, maintain a focus on offering appropriate services to the poor.

1. **Appropriate uses for grants.**

    - **Institutional development.** Support for institutional development is appropriate at all stages of an institution's life, and for a wide range of institutions, although the nature and extent of such support should evolve with the institution. Such support should become more selective, as institutions become able to meet more of their organizational development needs from within. It should also become more specialized, as institutions tackle more difficult problems.

    - **Capitalization**, or grants for equity are of strategic importance in enabling organizations to build a capital base. Capitalization can be used to generate investment income, build the loan portfolio, and leverage funds from local banks. One of the key purposes of providing capital funding is to enable institutions to mix costs of grant funds with commercial sources during the period it takes to build efficient operations and scale. Externally-financed capitalization should be used as a catalyst and complement to domestic mobilization of funds by local institutions. Grant equity contributions can also help institutions seeking to become formal financial intermediaries to meet minimum capital requirements.

    - **Operating losses.** Donors should avoid covering operating losses except during a clear, time-limited start-up or expansion phase. By the nature of the small loan business every program will take some time to reach a break even point. Donors should be willing to provide support during that time. Afterwards, however, such support becomes counterproductive.

    - **Fixed assets**. Donors may wish to support purchase of fixed assets, such as computers, vehicles or premises. Such funding may be seen as contributions to the equity base of the institution.

2. **Appropriate uses of loans.** Donor support through loans is appropriate for lending-based institutions that meet performance standards. However, loan capital from local and commercial sources should be sought as early as possible, even at start-up. Care should be taken to avoid burdening young institutions with foreign exchange risk in loans denominated in foreign currency, unless adequate precautions are taken. Donors are also advised to be careful not to undermine savings mobilization efforts of savings-based institutions, such as

savings and credit associations by making loans available to them below the cost of mobilizing funds locally.

3. **Commercial sourcing of funds**. The transition to fully commercial sources of funding requires special forms of support that help introduce institutions to the financial system. Donors can act as catalysts to effect this transition through means such as:

   - **Investor equity**, from both official and private sources. Donor support can help leverage private investment.

   - **Second-tier operations**, which raise funds from commercial sources and onlend to microenterprise finance institutions.

   - **Partial guarantees** of loans made by commercial banks to NGOs.

4. **Coherence of donor policies**. Institutions following sound principles for sustainability must not be undermined by others providing competing services below cost or in ways that cannot be sustained. When providing subsidies (grant or loan) to small and microenterprise institutions, donors should ensure that they coordinate that support with other funders, such that institutions are given clear incentives to become financially viable. In particular, donors need to consult each other regarding appropriate interest rates and other terms on which assistance to any given institution is supplied. Donors should also coordinate institutional support with sectoral policies such that financial institutions, including informal and semi-formal sectors, find enabling conditions for institutional development and growth.

ANNEX: MINIMUM REPORTING INFORMATION:

Donors should require regular reporting on institutional performance and should base funding decisions on achievement of performance targets. It is expected that every institution -- and the donors that support it -- will actively use **analytic indicators** to monitor the institution's financial condition. Examples include: net profit, average loan and savings account size, adjustments for subsidy and inflation, operational and full self-sufficiency, return on assets and equity, administrative costs as a percentage of portfolio (required spread), portfolio yield, and staff productivity. The intent is to ensure the quality and comparability of data so that financial analysis can be conducted in a way that both donors and programs can interpret.

The following tables cover the **minimum raw data** that should be reported, but do not include analytic indicators, such as financial ratios or adjustments for subsidy or inflation. In order to evaluate and compare performance, the raw data will have to be analyzed, through computation of ratios and other indicators. Informed opinions differ on which indicators are most important. Therefore, this document makes no attempt to specify those indicators. Rather, it provides for an information base of raw data to use in the calculation of a range of key ratios.

Portfolio and Outreach[1]

1. Number and amount of loans outstanding at beginning and end of reporting period	
2. Number and amount of loans disbursed during reporting period.	
3. Number and amount of small saver deposit accounts at beginning and end of reporting period. Show compulsory and voluntary savings separately.[2]	
4. Arrears (on a loans outstanding basis). Unpaid balance of loans with payments overdue more than 30 days. There should also be an aging of arrears report, covering, for example, 60 and 90 days and one year.	
5. Percentage of female clients.	
6. Number of staff (only those involved with savings and credit activities).	

[1] For institutions that offer a full spectrum of financial services, information should apply only to that portion of the institution's activities and overheads focued on small and microenterprises.

[2] Many programs require clients to deposit minimum amounts or pay into savings funds in order to be eligible for loans.

Interest Rate Policy

7. Effective annual interest rate paid by clients (incorporating all required fees, and calculated on a declining balance basis), both nominal and real. Effective rate paid to savers.	
8. Local annualized interbank lending rate and 90-day CD rate.	
9. Local annual inflation rate (give source).	

Income and Expense Information

INCOME	
10. Interest and fee income from loans (excluding accrued uncollected interest on non-performing loans)	
11.Income from investments	
12. Other operating income from financial services	
EXPENSES	
13. Staff expenses (salaries and benefits)[3]	
14. Other administrative expenses (includes depreciation)	
15. Loan losses. All loans over one year in arrears should be written off, as far as local rules permit. Institutions should describe their criteria in recording loan losses.	
16. Interest and fee expenses (itemized by source of funds)	
17. NET OPERATING PROFIT	
18. Non-operating income	
19. Non-operating expenses	

20. Donations:	
20a. For operating expenses	
20b.Capital contribution (identify purpose, e.g., loan fund, equity, fixed assets)	

[3] Staff and administrative expenses should be those that relate to the provision of financial services. If an institution has significant non-financial activities, it should account for those costs separately, including the proportion of overhead expenses needed to support those activities. Costs paid directly by donors, such as expatriate salaries, should be included.

Balance Sheet Information

ASSETS	
21. Cash on hand and in banks	
22. Mandatory reserves	
23. Short term investments	
24. Loans outstanding (must match indicator 1, above)	
25. Less: Loan loss provisions	
26. Net portfolio outstanding	
27. Long term investments	
28. Fixed assets (after depreciation)	
29. Other assets	
30. TOTAL ASSETS	
LIABILITIES	
31. Savings and time deposits from target group clients (must match indicator 3, above)	
32. Other deposits	
33. Loans from central bank	
34. Loans from other banks	
35. Other short term liabilities	
36. Other long term liabilities	

EQUITY	
37. Paid in equity (shareholders)	
38. Donated equity	
39. Retained earnings	
40. Other capital accounts	
41. Current year profit or loss	
42. TOTAL LIABILITIES AND EQUITY	

Microenterprise Development Brief
Number 12 September, 1995

CALCULATING EFFECTIVE INTEREST RATES ON MICROCREDIT LOANS[1]

A microcredit interest rate quoted at 3% per month may be equivalent to a much higher "effective" rate, depending on how the loan and its repayment are structured. The real cost to the borrower, and the real income generated by the lending institution's loan portfolio, can be raised significantly by practices such as:

-- Computing interest on the original face amount of the loan, rather than on the declining balances which actually remain in the borrower's hands as successive installments of principal are repaid (known as "flat" interest charges);

-- Requiring payment of interest at the beginning of the loan (as a deduction from the amount of principal disbursed to the borrower), rather than spreading interest payments throughout the life of the loan;

-- Charging a commission or fee in addition to the interest; or

-- Requiring that a portion of the loan amount be held by the lender as compulsory savings.

This note explains how to compute the effective interest rate on loans with combinations of these features. As used here, the effective interest rate of a particular loan contract is the rate which a client is "really" paying, based on the amount of loan proceeds actually in the client's hands during each period of the life of the loan.

A basic financial calculator is sufficient to handle the necessary computations.[2] The user enters the known loan variables, and the calculator computes the remaining variable:

PV Present Value: the **net** amount of cash disbursed to the borrower at the beginning of the loan.

i Interest Rate. Must be expressed in same time units as **n**, below.

n Term of the loan. Must equal the number of payments to be made.

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[1] This note follows a simplified approach to computing effective interest rates. It does not include the effect of compounding of interest.

[2] Alternatively, the computations can be performed using the financial functions of a computer spreadsheet application such as Lotus 1-2-3.

PMT Payment made each period.[3]

FV Future Value. The amount remaining after the repayment schedule is completed. Zero except for loans with forced savings. (See Alternative 7.)

The illustrations below include a Base Case and 7 Alternatives. In the Base Case, where interest is calculated on declining balances, the calculator is used to determine the necessary monthly payment amount. Each of the Alternatives involves two steps: first, the actual cash flows received and paid by the client are computed; then those cash flows are entered into the calculator to determine the effective rate.

BASE CASE: **Declining Balance.** Loan amount is $1000, to be repaid in 4 equal monthly payments of principal and interest. Interest rate is 36% per year, calculated on declining balances -- i.e., the interest is charged only on the amount of the loan principal which the borrower has not yet repaid. In the base case the effective interest rate is the same as the stated rate.

Compute Monthly Payment: PV = 1000; n = 4; i =36/12= 3. Solving for PMT yields a monthly payment of 269.03.

ALTERNATIVE 1: Up-Front Interest Payments. Same as Base Case except that all interest is charged at the beginning of the loan.

Compute Cash Flows: Total payments of principal plus interest in the Base Case were 1076.12 (269.03 X 4). Subtracting 1000 of principal gives total interest of 76.12. Since this is paid up front, it is equivalent to deducting the amount from the loan disbursement, leaving the borrower with a net cash disbursement of 923.88 (1000 - 76.12). Monthly payments are principal only, in the amount of 250 (1000 / 4).

Compute Effective Interest Rate: PV = 923.88; PMT = -250;[4] n = 4. Solving for i yields an effective monthly rate of 3.24%, which is multiplied by 12 for an annual rate of 38.9%.

ALTERNATIVE 2: Initial Fee. Same as Base Case except that a 3% loan commission is charged up front.

Compute Cash Flows: Net actual disbursement to the borrower is 970 [1000 - commission of 30]. Monthly payments are 269.03, as calculated in Base Case.

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[3] Microloans are usually structured so that the borrower's payment is the same each period. Where the payment amount changes from one period to another, the computation requires a calculator with an Internal Rate of Return function, or a computer spreadsheet.

[4] On most financial calculators, present value and payment must be entered with opposite signs: i.e., if PV is positive, PMT must be negative, or vice versa.

Compute Effective Interest Rate: PV = 970; PMT = -269.03; n = 4. Solving for i yields an effective monthly rate of 4.29%, which is multiplied by 12 for an annual rate of 51.4%.

ALTERNATIVE 3: Weekly Payments. Same as Base Case, except that four months' worth of payments are paid in sixteen weekly installments.

Compute Cash Flows: Total payments of 1076.12 [269.03 x 4] are broken into weekly payments of 67.26 [1076.12 / 16].

Compute Effective Interest Rate: PV = 1000; PMT = -67.26; n = 16. Solving for i yields an effective weekly rate of 0.88%, which is multiplied by 52 for an annual rate of 45.6%.

ALTERNATIVE 4: Flat Interest. Same as Base Case, except that flat interest is calculated on the entire loan amount, rather than on declining balances, and is pro-rated over the four monthly payments.

Compute Cash Flows: Total interest is 120 [1000 x 3% x 4 mos.]. Total principal plus interest is 1120 [1000 + 120], or 280 each month [1120 / 4].

Compute Effective Interest Rate: PV = 1000; PMT = -280; n = 4. Solving for i yields an effective montly rate of 4.69%, which is multiplied by 12 for an annual rate of 56.3%.

ALTERNATIVE 5: Flat, with Up-Front Interest. Same as Alternative 4 -- interest calculated each period on entire loan amount -- except that all the interest is paid up front at the beginning of the loan.

Compute Cash Flows: Total interest is 120, paid upon loan disbursement. Thus, the borrower's actual net disbursement is 880 [1000 - 120]. Monthly payments of principal are 250 [1000 / 4].

Compute Effective Interest Rate: PV = 880; PMT = -250; n = 4. Solving for i yields an effective monthly rate of 5.32%, which is multiplied by 12 for an annual rate of 63.8%.

ALTERNATIVE 6: Flat, with Up-Front Fee and Interest. Flat interest is charged on entire loan amount; total interest plus a 3% commission are collected up front, at the time of loan disbursement.

Compute Cash Flows: Total interest is 120 [1000 x 3% x 4 mos.]. Net actual disbursement to client is 850 [1000 - interest of 120 - commission of 30]. Monthly payments are 250 [1000 / 4].

Compute Effective Interest Rate: PV = 850; PMT = -250; n = 4. Solving for i yields an effective monthly rate of 6.83%, which is multiplied by 12 for an annual rate of 82.0%.

ALTERNATIVE 7: Savings Requirement. Same as the Base Case, except that the client is required to make a savings deposit of 50 along with each month's payment. The savings deposit yields interest of 1% per month, uncompounded, and is available to the client for withdrawal at any time after the end of the loan.

Compute Cash Flows: The disbursement to the borrower is 1000. Monthly payments are 319.03 [269.03 p + i as calculated in Base Case, plus savings deposit of 50]. At the end of the loan, the savings account yields the client a future value of 203 [200 in deposits plus interest of 0.50 for the second month, 1.00 for the third, and 1.50 for the fourth].

Compute Effective Interest Rate: PV = 1000; PMT = - 319.03; n = 4; FV = 203. Solving for i yields an effective monthly rate of 3.26%, which is multiplied by 12 for an annual rate of 39.1%.

This note was prepared by Richard Rosenberg.

Bureau for Global Programs, Economic Growth Center, Office of Microenterprise Development
1300 Pennsylvania Avenue, NW, Washington, DC 20523 Tel.: (202) 712-5967, Fax: (202) 216-3593

USAID

United States Agency for International Development
Microenterprise Development Brief
Number 13 Updated July 1996

Microenterprise Innovation Project (MIP) At A Glance

Component	Short Description	Implementor	Access or Contract Mechanism	Key Activities
Implementation Grant Program (IGP)	Provides co-financing for U.S. PVOs and other experienced organizations to implement Microenterprise Projects	G/EG/MD	Grant applications received and approved by G/EG/MD in response to yearly RFA and based on a competitive process.	Grants for Implementation
The PRIME Fund	Provides co-financing for Mission Microenterprise projects.	G/EG/MD	Projects reviewed and approved by G/EG/MD in response to Mission application and based on a competitive process. Budget allowance made to Mission.	Grants for Implementation
Microenterprise Best Practices (MBP)	Undertakes a core action research agenda & manages a small sub -grant fund for training & information exchange among practitioners & to support pilot projects on a limited basis.	DAI, with subcontractors: ACCION, FINCA, HIID, IMCC, Opportunity International, OSU,SEEP	Collaboration with G/EG/MD in setting & participating in core agenda field studies.	Action Research Training Information Exchange Electronic Communications
MicroServe	Provides short-term technical assistance (<6 mos.) to Missions, Regional & other Bureaus and implementing agencies on a request for services (RFS) basis.	Chemonics Weidemann Associates, et al.	Request for services, drafted by Missions & reviewed by G/EG/MD.	Technical Assistance in Project Design, Implementation, and Evaluation
Assessing the Impact of Microenterprise Services (AIMS)	Undertakes survey research, develops indicators & tools to assess impact.	MSI with HIID, SEEP & U of Missouri	Request for services, drafted by Missions and reviewed by G/EG/MD. OYB transfer.	Research, Impact and Evaluations
Linkage Component	Leverages other donors' involvement in microenterprise.	G/EG/MD	Collaboration with G/EG/MD	G/EG/MD buy-ins, PASAs, RSSAs, IPAs, agreements with other donors.

Bureau for Global Programs, Economic Growth Center, Office of Microenterprise Development
1300 Pennsylvania Avenue, NW, Washington, DC 20523 Tel.: (202) 712-5967, Fax: (202) 216-3593

United States Agency for International Development
Microenterprise Development Brief
Number 14 October 1995

Microenterprise and Agribusiness[1]

What is a Microenterprise?
Rather than focus on a tight definition of a microenterprise, it useful to think in terms of a general description. Microenterprises are the small, informally organized businesses of resource poor households. For program purposes, USAID has set a threshold for microenterprises at 10 employees. That is, at 10 employees and beyond, and enterprise is considered to be a small business.

The goals for *microenterprise*s are to increase income and assets, to improve skills and increase productivity, and to improve the microentrepreneur's position in society, through increased income, and through involvement in associations and organizations.

The purpose of *microenterprise support organizations* is to increase their program outreach, to be cost effective and to push themselves toward financial self sufficiency, and to support innovative ideas in the field of microenterprise.

The **Microenterprise Innovation Project** (MIP) is USAID's umbrella project for microenterprise activities. It has 6 project components to provide support in the areas of implementation, research, training and technical assistance and information exchange. MIP supports both financial activities, such as savings and credit, and non-financial activities that improve management and break down market and infrastructure constraints. All of this is supported with an eye toward financial cost effectiveness, self-sufficiency and independence from donor funds.

Identifying Agribusiness Opportunities
Enterprises involved in direct agriculture production, that is, small farmers, in the context of their farming activities, do not fall under the microenterprise rubric. Farm household value added and non-farm activities, however, might be microenterprises. There is an historical reason behind the exclusion of farmers from the microenterprise definition. Basically, the growth of microenterprise support programs resulted from the fact that agriculture programs were not reaching the many microenterprise activities that were present in developing countries. In some countries microenterprises support more than a third of the labor force.

By separating agriculture and non-agriculture activities it is possible to separately address the hard and soft technology needs of these enterprises. But this is not to suggest that there are not

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[1] Based on presentation by Anicca Jansen at USAID/Agriculture Enterprise and Market Development Division Agribusiness Workshop, June 16, 1995.

overlaps. In fact, if the backward linkages in agribusiness activities were explored, microenterprises would probably show up as a key factor. In some cases there may be thousands of microenterprises behind a given agribusiness activity. Unfortunately, at this time these linkages are not well documented.

In order to support microenterprise activities linked to agribusiness, it is important to think about the types of problems microenterprises face:

> ***Product differentiation*** - microenterprises tend to operate in saturated markets. This is because microenterprises are concentrated on activities that have low entry and exit costs, in terms of capital and in terms of information costs. A typical microenterprise begins when someone decides to sell or produce a product that they have seen someone else selling or producing. This leads to saturated markets.
>
> ***Scale*** - related to market saturation, it is difficult for a microenterprise to increase its scale in an over-saturated market. Other constraints affecting scale include inadequate production, storage, and marketing space, poor business skills related to financial management, poor access to sound credit and savings mechanisms, and poor linkages to broader markets.
>
> ***Risk*** - risk aversion is high among microentrepreneurs. This is partly the result of being resource poor, but primarily related to access to information. The microentrepreneur does not have enough information to accurately assess or to decrease the risk of increasing scale of production or moving into a new line of sales and production.
>
> ***Low-value products*** - microenterprises are low on the value added chain. This is related to the market they serve, primarily a poor, domestic market, as well as their access to technology. Microenterprises generally do not have the technology or related skills needed to significantly add value to a product.
>
> ***Market links*** - as mentioned above, microenterprises tend to serve a poor local market. When their activities do serve a higher income, and/or export market it is almost exclusively indirectly through larger, more formal enterprises. And they tend to have little control in these transactions.

Agriculture and Microenterprise Credit

A considerable focus of the USAID Microenterprise Development office is on improving microenterprise access to financial services, or microfinance. By definition, agriculture credit is not microfinance credit. On the other hand, there is a shift in thinking surrounding microfinance, which is tending to make such distinctions obsolete. The microenterprise is increasingly seen as part of a set of household activities. Rather than the microenterprise being the borrower, the household is seen as the borrower. Under this framework, the household is a black box into which different types of credit flow, finances are allocated according to household needs, and loans are repaid, out of whatever activity produces the funds to do so.[2] Taking this approach there is less of a need to distinguish between agriculture and microenterprise credit. But, from the users' standpoint, agriculture credit banks provide a narrow set of services that do not meet all the financial service needs of people in rural areas.

There are other problems associated with agriculture credit as well. Agriculture credit has the reputation of being a centralized, inefficient publicly owned effort, sometimes misused as a mechanism for borrowing or accessing foreign exchange, rather than as a domestic financial service. Agriculture credit banks are sometimes criticized as being established more for non-financial than financial purposes and often without the aim of achieving financial self-sufficiency.[3]

But agriculture credit banks house a certain degree of capacity upon which a sound financial system could be built. Bank Rakyat Indonesia (BRI) is an example of a successful microfinance program that grew out of a failed agriculture credit system.
As with BRI, an established agriculture credit bank will have with it infrastructure, including branch offices, and information and human capital.

To revamp agriculture credit banks into a useful rural financial system requires certain key factors:

- the addition a savings mechanism, followed by deposit mobilization;
- capitalization;
- favorable government policies, including freedom from interest rate controls and other financially crippling dicta, from the Ministry of Agriculture, for example;
- decentralization;
- sound financial performance; and
- a diversified portfolio.

Broadening into microfinance lending can add stability to agriculture credit banks by adding to portfolio diversification.

Summary
There are several ways of linking agribusiness to microenterprises:

Broaden and revamp agriculture credit programs/institutions.

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[2] "A Framework for Assessing the Impact of Microenterprise Interventions at the Level of the Household, the Enterprise, the Individual and the Community" January 1995 DRAFT. Jennefer Sebstad, Catherine Neill, Carolyn Barnes and Gregory Chen.

[3] "Public Agriculture Development Banks: Lessons and Opportunities for Microfinance." By Claudio Gonzalez-Vega and Douglas H. Graham. Presented at USAID-Gemini sponsored Microenterprise and Agriculture Workshop. June, 1995.

Look toward broadening and revamping agriculture credit programs to meet broader rural finance needs.

Identify and build on microenterprise linkages that already exist.

Microenterprises play a critical role in production efforts, but these linkages are mainly undocumented. Identifying backward linkages with microenterprises is the first step in determining where microenterprises can be improved to increase the quality and scale of larger agribusiness activities.

Support value added microenterprise activities.

An example would be to promote specialty food production, such as making mango chutney or drying mangos.

Unleash microenterprise constraints

Larger firms can lessen space and financial constraints of microenterprises through direct assistance. Working with microenterprises through intermediaries who broker microenterprise networks of production, packaging and transport, reduces the cost of working with microenterprises.

Microenterprises can be helped considerably through increased access to information, technology and a larger, higher income market. Efforts to increase the degree and value of linkages to larger agribusiness firms in high growth areas will contribute considerably to the growth of microenterprises.

United States Agency for International Development
Microenterprise Development Brief
Number 15 October 1995

Maximizing the Outreach of Microenterprise Finance

Background

Microenterprise finance is a prominent part of USAID's economic strategy for reaching the poor. During FY1995, USAID has allocated $140 million for microenterprise funding. Conventional wisdom holds that microenterprise finance is desirable because it helps poor people, but is too costly to be profitable. USAID's Center for Development Information and Evaluation (CDIE) recently completed an evaluation of successful microenterprise finance programs that found this view wrong.

From rural Bangladesh to urban Bolivia, with a range of clientele and average outstanding loans as low as $32, microfinance institutions were able to cover day-to-day costs and reach large numbers of poor people. Five of the 11 institutions studied were fully profitable, generating inflation-adjusted positive returns on assets. Five others covered their operating costs without outside assistance.

Past efforts using subsidized directed credit often failed because lending institutions became decapitalized, funds didn't reach intended groups, and programs distorted financial markets. The programs studied learned from past mistakes. They are charging interest rates and fees that cover the costs of delivering financial services, and they are embracing financial self-sufficiency as a primary goal.

The purpose of the CDIE study was to identify elements critical to the success of microenterprise finance programs and to determine performance standards. It assessed performance from two perspectives: outreach, or access by the very poor, and financial sustainability.

The study used the criteria of loan size (a rough proxy for client income level), number of borrowers (a proxy for scale), and reputation for financial strength. Institutions studied were the Unit Desa System of the Bank Rakyat Indonesia (BRI), Lembagan Perkreditan Desas of Indonesia, Badan Kredit Desa of Indonesia (BKD), La Asociación Dominicana para el Desarrollo de la Mujer of the Dominican Republic (ADOPEM), Actuar Bogotá of Colombia, Fundación Integral Campesina of Costa Rica (FINCA), Banco Solidário S.A. of Bolivia (BancoSol), Kenya Rural Enterprise Programme (K-REP), Agence de Credit pour l'Entreprise Privée of Senegal (ACEP), Bankin Raya Karkara (BRK) of CARE in Niger, and the Grameen Bank of Bangladesh.

Findings
Significant outreach to the poor, including the very poor, can be achieved. Clients of these institutions were typically very small businesses without access to formal financial services, and many borrowers were women. Average loans outstanding were $200—$400. Scale, rather than exclusive focus on the poor, determines whether the very poor are reached. Mixed programs that serve a range of clients have successfully reached large numbers of the very poor.

Operational efficiency can be achieved consistently in a range of geographic settings. Ten of the 11 institutions were operationally efficient, covering the cost of day-to-day operations, including salaries and other administrative costs, from interest and fees. Five were fully profitable—program revenues covered both operating costs and the financial costs of obtaining funds on a commercial basis.

Financial Viability of Microenterprise Finance Programs. 1993

Program	Operational Self-Sufficiency	Return on Average Assets
LEVEL I: Subsidy Dependent		
BRK	44	-11.5
LEVEL II: Operationally Self-Sufficient		
K-REP	106	-18.5
FINCA	98	-6.3
Grameen	105	-3.3
ADOPEM	94	-0.8
ACEP	142	0.1
LEVEL III: Profitable		
BancoSol	107	1.0
BRI	113	1.6
BKD	197	3.2
Actuar	124	4.9
LPD	148	7.4

Programs are reaching large numbers of poor people. Institutions in Indonesia and Bangladesh have achieved coverage on a national scale. The Grameen Bank covers almost half the villages in Bangladesh, and the BRI's Unit Desa system has more than 2 million borrowers and 12 million savers.

Programs are rapidly increasing their client base. Clients are increasing by 25 percent to 100 percent a year in programs assessed. Actuar Bogotá in Colombia, for instance, increased from 7,000 clients in 1990 to 54,000 in 1993. Programs have achieved this by maintaining financial viability—controlling bad loans, holding down administrative costs, and developing a rapidly growing base of financial resources.

Client demand for these programs is strong. That is evident in the growth in the number of borrowers, the loan portfolio and, in some cases, savings. In addition, these programs experience low delinquency on loans, although most are charging interest rates significantly above inflation.

The effective real rate of interest charged is a key factor in self-sufficiency. In 1994, Actuar Bogotá, for instance, charged 71 percent interest on loans, which, with inflation at 19 percent, was the highest real effective interest rate of the group. It achieved a 4.9 percent real return on total assets. In contrast, K-REP in Kenya, where inflation was 47 percent, charged 38 percent interest, which translated into a real interest rate of negative 9 percent. K-REP also had the lowest average return on assets—negative 18.5 percent, although it did cover operational costs.

The relationship of the average salary of microfinance program employees to the gross national product per capita is also a significant factor in financial success. Programs that hired community staff at modest salaries had a significant cost advantage and greater likelihood of achieving profitability than those that arose from donor projects that stressed outreach and ignored financial viability. Those institutions tended to hire highly educated, relatively expensive employees.

Programs can achieve substantial outreach to the poor and be financially viable. These "frontier" programs, which made a decision to be self-sufficient, brought their cost structures in line with spreads available in local markets and adapted credit methodologies to market demands to achieve self-sufficiency.

Recommendations

Assess organizations' commitment to achieving operational efficiency and ultimately full self-sufficiency within a reasonable period. Management commitment should be visible in concrete targets and credible plans. Indicators of effective performance include:

- *Operational efficiency.* The organization should be working to develop an efficient, low-cost credit methodology; to control delinquency; and to rationalize its cost structure, particularly salaries.

- *Interest rate and fee policy.* Costs of services should be adjusted for inflation and priced to support financial viability.

- *Reporting standards.* Financial reporting should meet private sector standards and management should use the information effectively.

  Invest in institutions with the potential to reach full self-sufficiency and significant outreach. Provide support that fosters financial self-sufficiency, keeping in mind that it may require 5 to 10 years and substantial support. To determine whether an organization needs support, and if so, what type, find out what hurdles the program has to overcome to reach self-sufficiency:

- *Programs in start-up phase*. Concentrate on helping programs achieve operational efficiency, including establishing a lending methodology and operational strategy for service delivery.

  At this stage, donors often provide start-up capital. However, start-ups should be granted for a short time period—one project cycle. If efficiency is not achieved, cease support.

- *Programs achieving operational efficiency*. Focus on institutions committed to tapping other sources of funds, with concrete targets and plans. Place greater emphasis on improving financial performance reporting, meeting legal requirements to become a licensed financial intermediary or to gain access to commercial funding sources, and mobilizing savings to enhance institutional development.

- *Top-performing programs.* Consider helping in the transition to full independence. At this stage, stress mobilizing deposits, increasing capitalization through retained earnings or equity investment, and improving supervisory standards for microenterprise finance and strengthening policy dialogue with the government.

Source: Maximizing the Outreach of Microenterprise Finance: An Analysis of Successful Microfinance Programs. Robert Christen, Elisabeth Rhyne and Robert Vogel. Cressida McKean, Assessment Manager. Washington, DC: USAID. Program and Operations Assessment Report No. 10. July, 1995.

Microenterprise Development Brief
Number 16
September 1995

Providing Cost-Effective, Indirect Assistance to Microenterprises

To avoid the high-cost, low-impact trap common to firm-level nonfinancial assistance, support should not be aimed at individual microenterprises directly, but at intermediaries (usually larger firms) that can work with large numbers of smaller firms. These larger firms generally do not need help in bookkeeping, motivation, or marketing — the standard aid package for direct microenterprise training and technical assistance. They are more likely to need assistance in technological innovation and in the creation of new forms of business linkages with smaller firms that can help them and their collaborators access new markets.

Therefore, technology and business linkages are promising areas for indirect assistance. However, this does not mean that organizations that work on technological change or linkage promotion will be more cost-effective than others working in more "classical" assistance areas, such as firm-level training. The key to cost-effective indirect assistance is working with existing markets and making changes with the right actors in a way that helps both the larger and the smaller firms use their comparative strengths to achieve market gain.

What makes the difference between cost-effective and not-cost-effective work in technology and creating business linkages?

Technology

- Cost-effective work in this area requires involving enterprises, micro or larger, in the implementation of the technological change through a market system that can disseminate the change to many microenterprises. Work that is not cost-effective involves too-intensive technological tinkering that affects too few enterprises.

  Cost-effective change happened in the reeling technology in the Thai silk industry when a small number of larger manufacturing firms were taught to produce an improved reeler, which then became available to hundreds of silk producer microenterprises. At the other end of the spectrum is the Burkina Faso experience where several local and expatriate experts spent considerable time and effort to form one new company to produce new building materials and building designs. The experts hoped the company would set an example for many microenterprises to follow, but despite the technically interesting properties of their materials and designs, all the company succeeded in doing was building a few sample houses on its own property, and no microenterprises took up its technologies.

- Cost-effective technological innovation allows access to larger or more profitable markets. Change that is not cost-effective leaves the microenterprise serving the same market.

Changing from traditional to improved hybrid silk worms in Thailand enabled silk rearers and reelers to enter the more profitable and growing high-value domestic and export markets. Changing from a hand-tool to machine-based rice processors in Bangladesh, in contrast, left entrepreneurs in the same, flat domestic rice market, not necessarily increasing net returns to labor.

- Do not shoe-horn microenterprises into technical areas where they do not have competitive advantage. Use large firms when necessary to provide key inputs to open large markets to microenterprises.

  Helping medium-sized firms adopt prawn-rearing aquaculture technology opened up supplies of larvae to hundreds of microenterprises in Central Java, increasing their output and income. Attempts in Burkina Faso to get self-employed blacksmiths to manufacture farm equipment were almost a complete failure because these microenterprises could not compete, even with better micro-scale production technology, with larger, mass-producing enterprises.

Larger Firm Linkages with Microenterprises

- *Linkages that are cost-effective connect many microfirms with one or a few larger ones, not one with one.*

  Linking the Jim Thompson silk company with a hundred yarn suppliers in a new supply village was worth the extensive brokering effort CARE staff had to put in to close such a deal, because it provided thousands of microenterprises with a new buyer at far higher returns to labor. By contrast, many mentoring programs, where one big business tries to help its microenterprise partner along, have few success stories and many critics decry their paternalism. Even when the microenterprise is assisted by the mentor, the increased revenue is rarely commensurate with the real cost of the mentorship effort.

- *Linkages that are cost-effective occur in subsectors where it makes economic sense to disaggregate functions in the production and marketing system.*

  Construction, which involves many disparate functions, each one of which varies from job to job, is a subsector that lends itself to linkages. Larger contractors or developers contracting with several microenterprises are common occurrences in more open market economies. GEMINI has yet to find a country's construction subsector in which both large and micro firms could not benefit from increased linkages. Tool and dye manufacture, by contrast, involves a limited number of standardized processes, and is not an area in which disaggregating production through subcontracts benefits either size of firm. Although it has been possible to teach individual carpenters, using certain components provided from larger firms, to make carpentry hand tools in Malawi and Zimbabwe, the only commercially promising handtool production concern is a medium-sized manufacturer making the tools completely in-house.

- *Linkages based on profit motive in the large firm have a far higher chance of working than linkages based on corporate altruism or social responsibility.*

  A large exporter of herbal teas and other processed agricultural products in Lima, Peru, has provided increased income for hundreds of farm families in rural areas by setting up small drying facilities that purchase their semi-processed products (camomile, mint, and other herbs). The exporter set up these facilities because they raised his product quality and lowered his production costs. Before, he purchased only in Lima from wholesalers, and could not obtain all the raw materials he needed to meet customer demand. Both he and his suppliers are profiting from these new linkages.

By contrast, in South Africa a major petroleum products company was under pressure, along with all other large companies, to do more business with black entrepreneurs. It figured that it could increase its markets for kerosene, an important cooking and lighting fuel in the townships, by making subcontracts with black entrepreneurs to make sales and deliver fuel in these areas. The company then took some of its underemployed middle managers and black employees and made them the corporate managers and subcontractors of this new scheme. It also donated some of its oldest and least useful transport fleet to the program. It did not fare well. The consultant who reviewed the program rightly pointed out that it did not have a chance of working well, regardless of market opportunity, because the underlying motivation of the large firm lacked any profit motive other than social image profit.

A Case Study in Cost-Effective Indirect Assistance: The Kenya Ceramic Jiko

The Kenya Ceramic Jiko (KCJ), an energy-efficient charcoal stove made of metal and ceramic parts, makes a great nonfinancial assistance success story for several reasons. First, it involves both technological innovation and large micro-business linkages. Second, it was the first significant commercial success in a development area characterized (and still dominated) by enormous investments with little return, mostly in intensive, firm-level assistance to microenterprise stove makers. Finally, the KCJ's success has helped not only thousands of artisan entrepreneurs who make and sell the stoves, but also tens of thousands of households in eastern and southern Africa that save money and time through using more efficient cooking devices.

What was done right in Kenya in the early 1980s that helped the KCJ industry take off?

- *The USAID-funded contractor institution supporting new stove development, unlike most other assistance organizations, investigated not only existing stove designs but also the existing stove industry.*

  Stove technology work in the early 1980s was dominated by an engineering mentality: basically, if we build it more thermodynamically efficient, all the business problems would solve themselves. Assistance organizations spent lots of time in painstaking examination of existing designs, but no time in understanding how stoves got from raw materials to markets. The KCJ group took a different tact. They saw a thriving artisan metalwork sector in Nairobi, and decided to find ways to get this group involved in new technology development and dissemination. They spent time with stove producers, learned where they got their materials, what they could and could not do in fabrication, how they sold their products, to whom they sold, and how they financed the entire process. This information enabled them to make use of the highly sophisticated and highly efficient networks currently supplying stoves to a large and fast-growing urban population.

- *Unlike their colleagues at work in many other countries, the engineers working on the design of the new stoves involved a few master artisans in creating a design that was practical for existing stove makers.*

  The existing square metal charcoal stove had plenty of engineering deficiencies, but from a business point of view, it had many advantages. It was easy to make from the scrap metal materials the artisans used. It was lightweight and easy to use in the home. The assistance providers were familiar with a metal-ceramic stove widely used in Thailand, and felt that this type of fuel-efficient stove would work in Kenyan homes. But the Thai design needed wide sheets of metal not often found in the scrap supplies in Nairobi.

The project staff exposed a few master artisans to the Thai ideas and encouraged them to suggest how it might be adapted for Kenyan production conditions. The result was the bell-bottom design that allowed narrower metal strip construction and reduced the ceramic needs of the stove at the same time. Perhaps just as important, as soon as the master artisans began tinkering with these design modifications, their many artisan neighbors in open-air market areas such as Shari Moyo began imitating them, and KCJ production took off.

- *After some initial disappointments working with self-employed potters, the contractor concluded that larger ceramic products firms needed to be involved in stove production, and invested considerable time in getting two larger firms to buy into a stove production venture with microenterprises.*

The assistance providers, like many involved in development assistance, initially tried to implement the KCJ development program using only poor microenterprise entrepreneurs. They, like their peers, felt more secure working directly with the poor because this was their image of how development should work. But the providers ran into problems with production of the stove ceramic liners. These components, which were critical to the KCJ's improved efficiency, required a far higher level of production quality control than the metal claddings. They also required certain raw materials, such as perlite (a mineral additive that increases the insulation properties of the ceramic mix), which were not easy to obtain because they had to be trucked in from rural quarries in large quantities. This led the assistance providers to turn to two medium-sized ceramic product firms which, with some training from the program, began producing ceramic liners.

The KCJ project helped link these larger firms to large numbers of artisan metalworkers who provide claddings that the ceramic products companies had neither skills nor comparative advantage to manufacture. Two medium-sized firm liner production lines eliminated the main bottleneck to getting large quantities of KCJs on the street. These firms also helped eliminate other marketing problems (see below).

- *KCJ promoters concentrated on encouraging existing stove makers to produce the new model; on using existing market channels for stove sales; and on letting the entrepreneurs, big and small, work out distribution, pricing, and other marketing matters themselves.*

The KCJ project, having started with commercial operators, was spared the difficulties many other stove programs had with getting the new models to market. The artisans used their old channels to distribute and sell their new stoves. The project helped with some general advertising and public awareness campaigns, led by the Minister of Energy, but it stayed out of more direct marketing activities. There were still marketing problems, but the new linkages between large and smaller firms offered better ways to resolve these than any solutions outsiders could have devised.

For example, the metal-working artisans were always short of cash and could not easily have purchased stove liners from a microenterprise supplier. But the medium-sized firms were prepared to extend microenterprises credit or to accept claddings in exchange for finished, lined stoves. When the initial stove prices were three times those of traditional metal charcoal stoves, the KCJ project staff, rather than trying to intervene and fix prices, concentrated on getting more producers making the KCJs. Prices soon fell to less than half the starting level. At this lower price, the average household recouped its investment in a KCJ, even at the higher prices, in only a few months because of fuel savings.

Today tens of thousands of KCJs are made and sold each year, not only in Kenya but throughout eastern and southern Africa. Thousands of microenterprises have increased their incomes through this new product, which has found strong demand in fuel-scarce, rapidly growing urban areas. Before the KCJ program, the stove technology field had been characterized by high investment for relatively low impact, with great quantities of engineering time going into the production and sale of only a handful of new stoves.

The KCJ assistance program, although it involved an intimate relationship with a few key microenterprises (the master artisan firms), actually spent far more time working with larger firms (the ceramic product manufacturers) and with senior government officials whose public support rallied attention and market interest. This more indirect, more market-oriented approach led this program to support the work of hundreds of entrepreneurs while providing a good technology for poor consumers.

Source: *Power from the People: User Involvement in Energy Technology and Innovation*, Matthew Gamser, London: IT Publications, 1988; "The Introduction of the Kenyan Jiko Stove — A KENGO Experience," Monica Opole, in *Sustainable Industrial Development*, M. Carr, London: IT Publications, 1988.

Microenterprise Development Brief
Number 17
September 1995

Beyond Self-Sufficiency: Licensed Leverage and Microfinance Strategy

Despite the success of microfinance programs in numerous countries worldwide, 95-99 percent of poor households in most countries have not been reached by these programs. Rough calculations of potential market size reveal a need for microfinance assets far in excess of donor funding available for the purpose. Because there are not enough donor funds to saturate the microfinance market, a key concern of donors ought to be "leverage": for each dollar of donor funds invested in an institution, how many additional dollars can be mobilized from commercial sources?

Five Levels of Leverage

At Level One, a microfinance program does not break even on a cash-flow basis. At this level, for one dollar from a donor today, there will less than a dollar still available to provide ongoing finance for poor people.

At Level Two, the institution does break even and may be self-sufficient; however, most of its portfolio is financed through loans from donors. Because the institution has little or no equity, it cannot leverage its donor funds by borrowing from commercial sources. For every dollar put in by donors today, the program will have about one dollar available in later years for microfinance.

Level Three describes an institution that has reached break even or better but has substantial equity funding built through grants from donors rather than loans. Because it has a positive net worth, the program can expand its portfolio by borrowing from commercial sources. In this case, a dollar of donor money leads to about two dollars of resources available for poor clients.

Level Four is reached when the program has not only a self-sufficient cash flow and a significant equity base, but also a license as a formal financial institution. Because the program meets the requirements of a regulatory authority, outside parties are willing to loan or deposit money into the institution in amounts up to 11 times the institution's equity base.[3]

Level Five has not yet been reached. It refers to a situation in which programs make such high profits at level four that other investors start their own microfinance programs for purely financial motives.

3 [3]This limit is the international standard that has been adopted in many countries.

Strategic Considerations for Donors

- Donor microfinance support should be aimed at institutions already able to leverage funds or have credible plans to reach a point where they can. In other words, institutions should already be operating at Level Three.

- Donors should prefer grant financing to loans because, instead of increasing the institution's equity base, loans add to the its debt and lower its ability to leverage commercial funds.

- Donors must set their strategic sights at saturation of the microfinance market — a goal whose achievement will require the use of models that provide high leverage of donor funds.

Three Conditions for Development of Level Four Institutions

Three requirements emerge as conditions for the development of institutions able to leverage commercial funds at Level Four and thus meet the demand for microenterprise finance.

Equity. They must have a substantial equity base. This can be accomplished through not only routine donations but also infusion of equity capital by donors who take an equity stake in the institution or who donate funds through a third party who becomes a shareholder. In some countries, a subordinated debenture — a loan to the institution that is subordinated to the rights of the institution’s other creditors — can be considered equity.

Access to Licensing. They must have access to a credible and competent financial regulatory agency. Licensing and supervision of microfinance programs should be approached with great caution. There is limited practical experience in regulation of microfinance intermediaries. Microfinance institutions are inherently less stable than banks. Default by a microintermediary could lead to collapse of a country's entire microfinance system. It may not be necessary to license large numbers of microfinance institutions to achieve market saturation. Regulatory agencies in many countries have limited capacity or are too weak to provide a meaningful safeguard for microfinance depositors. In these cases, the donor should place a high priority on the institutional development of the supervisory agency.

Technical Input. Institutions will require ongoing technical input to support their transformation into a professional and efficient financial intermediary. This input should be provided by practitioners who have extensive experience with real microfinance programs combined with financial and systems expertise.

Source: "Beyond Self-Sufficiency: Licensed Leverage and Microfinance Strategy," Rich Rosenberg, USAID/G/EG, April 1994.

USAID

Microenterprise Development Brief
Number 18
September 1995

Managing Growth in Microfinance Institutions
Lessons from the ACCION Experience

ACCION International has been in existence since 1961, but the past eight years have seen an explosion in the size and scope of the financial services it supports. Its network of 19 affiliates in Latin America and North America provides $300 million a year in loans to poor entrepreneurs (56 percent of whom are women). Since 1987, the ACCION network has grown from 13,000 to more than 285,000 active borrower clients. The six largest affiliates now provide $1 million per month in loans. BancoSol in Bolivia, which has grown from a credit-providing nongovernmental organization (NGO) to a fully licensed commercial bank, provides financial services to 67,000 people, more than one-half of the total number of clients in the entire Bolivian banking system. In addition, BancoSol led all Bolivian banks in return on assets in 1994 (2.2 percent return on assets).

ACCION INTERNATIONAL MICROENTERPRISE FINANCIAL INSTITUTIONS IN LATIN AMERICA
(data 1994 - preliminary)

Organization	No. of Clients	Portfolio ($ millions)	Avg. Loan ($)	Amount Disbursed (in 1994)	No. of Loans	Delinquency*
BancoSol	61,255	$33.1	$533	$76.3	143,037	0.97%
Corposol	51,999	$21.3	$660	$36.7	55,577	4.47%
ADEMI	14,274	$15.7	$1,769	$23.4	13,241	5.00%
FED	12,871	$4.2	$506	$12.1	23,798	3.60%
Genesis	10,024	$4.5	$752	$12.2	16,263	4.17%
ACP	9,023	$2.3	$374	$15.3	40,946	1.61%

* Delinquency > 30 days
ADEMI - Asociacion Dominicana para el Desarrollo de la Microempresa
FED - Fundacion Ecuatoria de Desarrollo
ACP - Accion Comunitaria del Peru

Reasons for Success

ACCION's most successful affiliates have three common ingredients behind their success:

1. They use appropriate lending methods.

   These lending methods are based upon obtaining thorough knowledge of the institution's markets, keeping costs low, motivating repayment, and (in most cases) using solidarity groups as a principal instrument to accomplish these three prerequisites. Without these methods, ACCION's affiliates could not have achieved the initial viability that lead them to consider further transformations.

   Today, lending methods receive less priority in the network, with more attention being given to the following factors, which are the second and third common ingredients in their success, and have been critical to the strongest programs' recent growth.

2. They focus on the development of strong financial institutions.

   Maintaining viability in rapidly expanding programs requires substantial investment in systems development, in human resources development, and in portfolio management improvement.

3. They link their affiliates to the commercial financial sector.

   Once an NGO microfinance program reaches a critical stage of growth, it cannot sustain its growth with classical donor support. These programs must transform themselves into formal financial institutions, so that they can access money more easily from local financial markets.

Areas Requiring Technical Support

Accomplishing the last two objectives requires technical support in three key areas: governance, financial planning and management, and staff development.

Governance

If an institution wants to access financial markets, it must compete shoulder to shoulder with other financial institutions. To do so, the institution must have the right private sector leaders on its Board. These Board members must be committed to the goals of the institution, and must be prepared to expose themselves financially to help it access larger funds from local and international markets. They serve as the guardians of the institutions' assets and the final arbiters of their performance. At the same time, they provide a key source of ideas and a link, through their personal contacts and reputation, to the formal financial sector.

ACCION complements the work of local directors by using its Bridge Fund to provide guarantees that help affiliates to obtain loans from local commercial banks. At a certain stage, however, such as that now reached by BancoSol and Corposol Bogota (ACTUAR), the microfinance institution tops out its borrowing capacity and must convert to a formal financial institution to increase its capital base further. This conversion requires a step up in financial planning and management.

Financial Planning and Management

Accessing financial markets while managing rapid growth requires major innovation in financial planning and management beyond that customarily employed in NGO microcredit programs. ACCION, through its recent experience in assisting its most successful affiliates in the transformation into formal financial institutions, has developed a two-faceted program of technical support for this transformation. The first part of this program is INCA, the *Instrumento CAMEL de ACCION*. INCA consists of a team of four to five experienced microfinance professionals spending 1-2 weeks with an affiliate to do a thorough assessment of the financial performance of the institution. Part of that assessment consists of the use of modified CAMEL (**C**apital Adequacy, **A**sset Quality, **M**anagement **E**fficiency, and **L**iquidity) analysis to produce key performance ratios for the institution. INCA also includes a management assessment, which concentrates on human resources, not on ratios.

The second part of the technical assistance package is the preparation of a multiyear business plan for the new financial institution by the technical assistance team and the management of the affiliate. The plan must contain clear, measurable performance targets and just-as-clear instruments for performance assessment. Few NGOs do such business planning, but it is critical for transforming an NGO into a financial institution that will be attractive to investors.

Human Resources Development

As ACCION's affiliates have grown in outreach (client numbers), they have also grown in staff size and organizational complexity. Maintaining a strong cadre requires creating clear career tracks and performance incentives. For example, outstanding loan officers should be able to become branch managers, outstanding branch managers, district managers, and so on.

ACCION has taken three initiatives to ensure that organizational development receives sufficient attention in its affiliates. First, it emphasizes the importance of regular staff training, both on-the-job and in dedicated time off-work. Second, ACCION helps its affiliates develop their own in-house training capacity, making sure that they all have human resource departments, and that these departments are upgraded as the institution grows and its personnel problems become more complex. Finally, ACCION convenes two-day management and communications workshops for its affiliates, which provide opportunities to discuss and resolve pressing human resources issues in the presence of senior human resource development advisors.

Source: Based on a GEMINI seminar presentation made by Michael Chu, President of ACCION, and Maria Otero, Executive Vice President of ACCION, to USAID staff and other interested microenterprise practitioners on April 28, 1995.

USAID

Microenterprise Development Brief
Number 19
September 1995

Regulation and Prudential Supervision for Microfinance Programs -- Making the Leap into the Formal System

As nongovernmental organizations (NGOs) begin to take savings and manage increasingly complex lending portfolios, formal principles of regulation and prudential supervision emerge as key issues in the success of microfinance programs.

Purposes

Prudential regulation and supervision are designed to:

- Avoid a banking crisis and maintain the integrity of the payments system;
- Protect depositors; and
- Encourage financial sector competition and efficiency.

Instruments of Prudential Regulation

Five central instruments are used in prudential regulation, each of which is designed with a specific purpose in mind:

- **Licensing Requirements:** The purpose of licensing financial intermediaries is to ensure adequate capitalization and sound management. Licensing should never be used to limit competition among institutions.

- **Capital Adequacy Requirements:** These provisions require deposit-taking institutions to maintain a minimum fixed amount of capital and prevent the ratio of equity capital to total assets from falling below a prescribed level. These rules encourage responsible behavior by the institution's owners because their equity capital will be reduced first by losses. One challenge for microfinance institutions is to define what qualifies as capital and how to treat off-balance sheet liabilities. More important, if the institution's owners are not clearly defined, other mechanisms are needed to induce disciplined behavior.

- **Insider Lending Restrictions:** Insider lending serves as one way for owners to reduce the risk imposed by capital adequacy requirements, thereby reducing the incentive for owners to manage responsibly. Setting rules to limit insider lending is particularly tricky for client-owned entities such as credit unions, village banks, and cooperatives. Additional mechanisms to promote internal control are required.

- **Diversification Requirements:** Diversification rules are designed to prevent concentration of an intermediary's loan and investment portfolio in a few individuals or groups of customers facing the same economic risks. Limits on concentration in the microfinance portfolios should be set as a function of the organization's equity capital.

- **Liquidity Requirements:** Through the mechanisms of liquidity ratios and reserve requirements, and by ensuring that the Central Bank acts as lender of last resort, the supervisory authority guarantees that institutions maintain adequate liquidity.

Principles for Prudential Supervision

- Supervisory activities should be confined to those of prudential regulation. Supervisory agencies should never manage financial intermediaries.

- Supervision should include frequent monitoring because risks and financial position change constantly in financial service markets.

- The system should be able to see trouble coming. It should have some ability to predict outcomes at different levels of interest rates and portfolio quality.

Issues in Regulating Microenterprise Finance Organizations

- Collateral and credit risks are more pronounced in microfinance organizations. Regulators need alternative means of valuing portfolios. Rather than collateral, best indicators of portfolio value may be past performance or current status of arrears.

- Most microfinance organizations offer one loan product to a limited clientele, which increases expertise and simplifies management while increasing risks. How can microfinance organization portfolios be diversified without overburdening management? Higher reserve requirements may be required by regulators in such situations.

- Lack of investor capital prevents microfinance organizations from taking savings. Although minimum capital requirements may be lowered for microfinance organizations, some level of investor capital should still be required.

- Prudential supervision should be flexible and neutral toward charter arrangements and market segments served by particular intermediaries. Flexibility is particularly important for loan loss provisions and collateral evaluations for microfinance organizations. The appropriate level of delinquency will also vary by type of clientele and loan products.

- Microfinance organizations face difficulties with managing liquidity risks. Regulators should insist that microfinance organizations maintain a level of solvency that allows short-term commercial borrowing to manage temporary liquidity problems.

- Microfinance organizations are often exposed to risk by donor demands. Regulations for microfinance organizations must ensure that internal controls exist that allow the institution to withstand a decline in grants or subsidized loans, and to resist unsafe demands from donors. The demands of supervision donors typically focus on performance measures that differ markedly from those necessary to assess the quality and health of the institution's portfolios.

Role of Governments and Donors

The issues above outline the difficulties and dangers in micro and small enterprise financial institutions becoming full-service microfinance organizations. Given these concerns, five points on the policy agenda should move forward:

- Governments should end financial repression and maintain sound financial policy: removing interest rate restrictions, limiting government absorption of credit, and keeping inflation low.

- Prudential authorities should carefully pilot-test special regulations for microfinance organizations. Flexibility is most called for in setting minimum capital requirements and allowing risk classification of micro and small enterprise portfolios according to delinquency performance rather than collateral.

- Prudential authorities should develop supervision mechanisms that build in self-supervision for member-owned institutions and internal controls for investor-owned institutions.

- In no case should capital adequacy ratios or liquidity ratios be relaxed.

- All changes should be undertaken with great caution.

Source: *The New World of Microenterprise Finance: Building Healthy Financial Institutions for the Poor* (Chapter Three, by Rodrigo Chaves and Claudio Gonzalez-Vega), edited by Maria Otero and Elisabeth Rhyne, West Hartford, Connecticut: Kumarian Press, Inc., 630 Oakwood Ave., West Hartford, CT 06110, USA, 1994. To order, call toll free: 1-800-289-2664.

Microenterprise Development Brief
Number 20
September 1995

The Role for Solidarity Group Lending in Microenterprise Financing

Internal Dynamics of Solidarity Group Programs

Solidarity groups are peer group lending schemes. Under such schemes, members receive loans and then make regular weekly or monthly payments, with all group members providing a mutual guarantee of loan repayment. This method differs from rotating savings and credit associations, in which group members make regular deposits and take turns receiving the full amount of the deposits. Solidarity groups have three principal goals:

- Providing services to the poor;
- Attaining financial self-sufficiency; and
- Reaching large numbers of clients.

Successful programs have a strong commitment to management efficiency and strive to be responsive to their market.

Features of Effective Credit Delivery in Solidarity Group Programs

Client Population. Group members must have an ongoing microenterprise or a proven ability to conduct their proposed business.

Group Self-Formation. Groups are responsible for selecting their own members and leaders. Groups are small and share collective responsibility.

Decentralized Operations. Program staff work in the communities, marketplaces, and shops, reaching borrowers at their place of work. This reduces borrower transaction costs and the cultural barriers that prevent borrowers from approaching formal sector financial institutions. Decentralized operations also allow agents to become familiar with group members, knowledgeable about current business conditions, and aware of events that affect borrowers.

Appropriate Loan Sizes and Terms. Borrowers in the group decide how much each member needs; then the sum of each loan is approved by the institution and lent to the whole group. Loan amounts begin small with short payback periods, allowing the entrepreneur to grow the business gradually. Loan terms are adjusted to fit the economic activities of the borrower.

Interest Rates and Service Fees. Revenue is generated from credit activities through a combination of interest rates, service fees, and the implicit costs of compulsory savings. Borrowing costs for solidarity groups are higher than those for commercial borrowers, although these rates are normally lower than those charged by money lenders.

Simple Loan Application and Rapid Review. With the backing of the solidarity group guarantee and the screening involved in group self-selection, loan review and approval can be performed quickly. Loan applications ask for simple, readily available information to assess the financial viability of the proposed activity, but fall short of formal project credit analysis. Well-designed questionnaires, visits to workplaces, and qualified staff are the key.

On-time Repayment Requirement. Peer group lending operations have developed a variety of incentives and sanctions to facilitate timely repayment. Group members are responsible for collecting the total loan, and no member is eligible for additional credit until every member of the group has repaid. Subsequent loans in larger amounts are made immediately to groups that repay on time.

Linking Credit to Savings and Other Financial Services. A safe and accessible savings facility is highly valued by group members. Savings form an intragroup emergency fund and facilitate repayment by serving as a safety net. Members can draw from the emergency fund to ensure on-time repayment in case of personal crisis. Member's savings can also serve as an important source of loan funds at the institutional level.

Training and Organization Building. Training and on-site technical assistance are integral to the solidarity group strategy. Cost-effective training allows group members to improve existing management and administrative techniques.

Borrower and Lender Accountability and Mutual Respect. By trusting members to manage their credit, meeting the clients' real business needs, and competently conducting the loan transaction, these programs call on group borrowers to fulfill their commitments to the program and to one another.

Innovations in Solidarity Group Methodology

Although core features of the solidarity group lending approach have withstood the test of time, programs continue to refine and improve delivery methods. Below is a discussion of innovation that have emerged in the main components of the methodology: financial services and training and technical assistance.

Financial Services

Loan Size and Payback Policy. Solidarity group programs have experimented with offering flexible loan amounts and terms that match the cash-flow requirements of the borrowing groups. However, they have found that a uniform policy for loan amounts and terms for at least the first year are important as a training phase that prepares group members to be responsible borrowers.

Upper Loan-Size Limits. Many solidarity group programs no longer specify an upper limit on loan size, which was originally intended to encourage successful borrowers to graduate to the commercial banking system. Instead, programs now offer additional financial services (for example, individual working capital and fixed asset loans) to keep valued customers.

Fixed Asset Lending. Fixed asset lending to groups to purchase common facilities or equipment has proved problematic, because adequate maintenance and time sharing were difficult and ownership controversies developed when groups disbanded.

However, programs have extended fixed asset loans to individual borrowers who have demonstrated borrowing history through group loans and who are endorsed by the group. The equipment serves as collateral, so the group does not have to guarantee the loan.

Savings. Group savings or emergency funds have become increasingly vital for peer group lending schemes. The savings are usually held in a savings account in the group's name. Group members must obtain permission from the program to use savings. This encourages enterprise capitalization and provides a cushion, and indirectly a kind of loan guarantee. As savings volumes grow, programs can use these funds as a negotiating tool for leverage with local financial institutions.

Life Insurance. A life insurance policy is taken out over the life of the loan and is intended to guarantee payment in case of the death of the borrower. Solidarity group programs have moved from serving as intermediaries between life insurance companies and borrowers to establishing and managing their own insurance funds.

Training and Technical Assistance

Training. Solidarity group programs have developed a two-tiered training program. The required portion focuses on group formation and loan programs. The optional portion responds to group needs in improving management techniques.

Technical Assistance. Technical assistance in the form of one-on-one counseling is used to follow up group training sessions. Advisers visit client businesses to reinforce the course material and assist in application of principals taught in group sessions.

Fees. Programs are encouraged to break out training fees as a separate component and not a percentage of the loans in addition to interest. All clients receive required training and whatever elective training they choose. By segregating training costs and fees, it is possible to avoid hidden subsidies; credit is not expected to cover the cost of inefficient training programs, and training operations are not being called on to subsidize cumbersome credit delivery methods.

Source: Excerpted from *The New World of Microenterprise Finance: Building Healthy Financial Institutions for the Poor* (Chapter Seven, by Shari Berenbach and Diego Guzman), edited by Maria Otero and Elisabeth Rhyne, West Hartford, Connecticut: Kumarian Press, Inc., 630 Oakwood Ave., West Hartford, CT 06110, USA, 1994. To order, call toll free: 1-800-289-2664.

Microenterprise Development Brief
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September 1995

Transformation Lending

Definition

Transformation lending is designed to bridge the gap between informal sector microenterprise lending programs and formal sector banks. Large and growing microenterprises find themselves caught in this gap when they become too big for the microenterprise development programs that gave them their start but are still too small to meet the requirements of formal financial institutions. Transformation lending programs seek to turn these microenterprises into small businesses by providing working capital and fixed-asset loans combined with training. Transformation is defined by increases in assets, productivity, and employment.

Needs of a Transforming Microenterprise

Microenterprise entrepreneurs often find that specialization leads to increased productivity. Specialization leads to the following changes in their business operation:

- Personnel shifts from family labor to hired labor. Personnel management becomes an issue.

- To secure stable markets, businesses expand past small neighborhood markets, sell to formal businesses, and identify and exploit their comparative advantages.

- Technology must be upgraded to meet increased production requirements and higher-quality standards.

- Supply needs change, because growing enterprises need secure, long-term supply sources.

- Greater reliance on purchased and processed raw materials creates an increased need for working capital credit. The need for tools and equipment creates an increased need for fixed-asset credit.

- Changes in cash management occur, and distinctions must be made between household and business funds.

These needs imply two key requirements for institutions seeking to support microenterprise transformation. First, programs must provide credit for both working capital and fixed-asset needs. Second, programs should consider providing additional services in the form of specialized training to help entrepreneurs adjust to the changes in business management, production processes, marketing channels, and sources of supply necessary for transformation.

Key Lessons of Successful Transformation Lending Programs

Financial Viability. Microenterprise lending programs that provide fixed-asset loans in combination with working capital have had greater success in reaching financial viability than programs that only offer long-term fixed-asset lending.

Credit Delivery. No matter what target group a credit program seeks to serve, it must obey certain principles of cost-effective credit delivery. These principles include simple procedures, good information systems, loan costs commensurate with loan income, decentralized program structures, and positive interest rates.

Lending Practices of successful transformation lending programs differ from those of programs that provide only working capital. Common practices are loans to individuals, variable terms, high loan ceilings, and higher collateral requirements for larger loans.

Clientele. One institution can still serve both expanding and transforming firms by offering various types of products and services.

Identification Methods. Program success requires developing a cost-effective means of identifying microenterprises capable of transforming.

Training Programs. Although targeted training programs may support transformation, they are not a necessary component of a successful program. Some successful programs offer no training. Others charge for optional training; still others offer mandatory training free of charge.

Beneficiaries are defined as those receiving loans and those who gain employment in new jobs created by microenterprises that receive loans.

Growth. Preliminary evidence suggests that transformation lending has proven to be successful in supporting the growth of microenterprises into small enterprises.

Source: *The New World of Microenterprise Finance: Building Healthy Financial Institutions for the Poor* (Chapter Ten by Larry Reed and David Befus), edited by Maria Otero and Elisabeth Rhyne, West Hartford, Connecticut: Kumarian Press, Inc., 630 Oakwood Ave., West Hartford, CT 06110, USA, 1994. To order, call toll free: 1-800-289-2664.

Microenterprise Development Brief
Number 22
September 1995

Operational Issues:
Designing Financial Services for Women

The experience of many programs that have developed ways to attract and serve the financial needs of women reveals certain characteristics of financial services that are appealing to female entrepreneurs in both cost and methodology.

Usefulness of Groups

Lack of collateral is a primary constraint to female participation in the formal financial system. *Methodologies that tap into workable alternatives for collateral have been the most successful in attracting women clients.* Joint liability and solidarity groups, pioneered by ACCION International and Grameen Bank, have proved to be just such mechanisms. Basing an entire group's qualification for a loan on the default history of each member creates tremendous peer pressure on all the members and is one of the most effective and least costly ways of motivating repayment.

Groups serve other needs as well, because they help women find work, spread information, offer training, and obtain access to resources. This is particularly true in societies in which women might be excluded from formal networks. Groups provide a setting in which women can learn and practice new skills before embarking on their activities. Group decisions can carry more weight and group cohesion often fosters peer learning.

Nevertheless, practitioners should follow certain guidelines to achieve appropriate group formation. For example, groups formed for political purposes should not be used for credit purposes, although the record is less clear for other types of preexisting groups. Groups of varied sizes have also had mixed success. Smaller groups of five to seven members work well in terms of joint liability, while larger groups serve more complex functions such as management and decision making.

Identifying, Attracting, and Targeting New Clients

To identify new clients, particularly women found in commercial and service sectors or those operating out of the home, *loan officers must be proactive and look beyond areas with high concentrations of manufacturing enterprises.* They must also develop creative radio advertisements or other audiovisual techniques because women are likely to be less literate than men. Practitioners may consider establishing programs for female clients only under specific circumstances, such as where women are in seclusion or where cultural values prohibit women from taking advantage of financial services. However, *the ultimate goal of a program should be the full participation of women in mixed-gender savings and credit programs.*

When targeting women is a short-term goal, the establishment of quotas can be a powerful tool to stimulate the incorporation of additional female borrowers. If they are to be employed properly, quotas should be determined during project design, should realistically reflect the proportion of women involved in the target group of microenterprises, and should be seen as positive motivators. *High percentages of women may also be attracted to a program simply because of appropriate project design, even without quotas.* For example, by emphasizing certain sectors such as services and trade, a project is likely to reach significant numbers of female clients. Targeting loans in the manufacturing sector, in contrast, will result in low female participation.

Gender of Loan Officers

The choice of male or female loan officers can affect the level of female participation in certain social contexts. Female promoters are necessary in strictly Islamic areas such as Pakistan or where social norms would limit the acceptable interaction between married women (clients) and men (loan officers), such as in rural areas of Latin America. Female loan officers can also serve as positive role models for female clients.

In areas where female loan officers are more desirable, some programs suffer from a shortage of qualified women either because women lack educational opportunities (Egypt, for example) or because safety issues preclude women from visiting clients at night (in urban areas). In such cases, it has been more acceptable for men to work with groups of women than to work with individual clients. Overall, the experience of the Grameen Bank suggests that *appropriately trained male bank workers can reach out to female clients.* Even though Grameen operates in an Islamic context, less than one-third of its field workers are female. Nevertheless, Grameen maintains its female participation rate of nearly 90 percent because its field staff are trained to understand the special dynamics and constraints of women and their businesses, and to develop qualities that inspire trust and confidence among rural women.

Deposit Services

Savings services should be designed to meet client needs and preferences. *In general, women want savings instruments that offer safety, convenience, ease of deposit, ready access to money, and a positive real return*. Financial institutions can also attract savers by creating products that mimic traditional savings products, such as rotating savings and credit associations. By offering attractive savings instruments, projects can tap new clients and reach deeper into the community.

Nonfinancial Services for Female Clients

Although several microenterprise programs offer technical assistance and training as part of their services, *training for women may require special attention*. Because first-time female clients may have not interacted previously with a financial institution, initial training should focus on credit consciousness, the responsibilities of the client, and how to be good savers and borrowers. Subsequent training could include courses on marketing and input supply, or on nonbusiness topics geared to women, such as household budgeting, use of income, family planning, child care, and personal empowerment. Many programs, often referred to as minimalist credit programs, have been successful without offering any training or technical assistance. Managers can assess the relative merits of a training program by charging cost-based fees for training services, thus ensuring that they are demand-driven.

Recommendations

The most important elements of a financial service program designed to attract more female clients are:

- **Loan Terms**: Credit should be available for entrepreneurs involved in trade and services, in addition to those in manufacturing. Loans should be approved in small amounts for short-term working capital, and repayment schedules should be frequent to correspond with women's business cycles. Loan size may be increased upon satisfactory repayment of first loans.

- **Qualifications**: Alternative guarantees to collateral (solidarity groups or character references) should be available. Neither the signature of a husband or male relative nor literacy should be a requirement. Home-based businesses should receive due consideration. Training should be optional and the approval process should be swift.

- **Services**: Deposit services offering safety, convenience, and a positive return should be available. Hours of operation should correspond with women's business and domestic obligations. Location should be accessible and safe for women. Operations should be decentralized, but should reflect strict banking rigor and discipline.

- **Training**: If offered, activities should be participatory and visual, and convenient for women to attend. Females should be used alongside males in illustrations and in any language referring to entrepreneurs. Training should be tailored to the literacy and educational levels of the audience.

- **Impact Analysis**: Data collected for any project purpose should be disaggregated by gender, particularly the number and amount of loans and savings accounts, the numbers of clients receiving technical assistance, and the number of clients by industry, sector, and activity.

Source: Excerpted from “Financial Services for Women,” GEMINI Technical Note No. 3, by Jean Weidemann.

Microenterprise Development Brief
Number 23
September 1995

Business Linkages and Microenterprise Development

Many microenterprises engage in only simple commercial transactions either with input suppliers or with purchasers of their products. Microenterprises may gather their raw materials themselves, while selling their output directly to their neighbors who are the final consumers. Such arrangements can leave them at the mercy of limited sources of supply for their inputs and restricted, localized markets for their sales.

Other microenterprises are involved in substantially more complex market transactions. They may purchase their inputs either as raw materials or as semifinished products from other enterprises that specialize in their production or marketing. These microenterprises may sell their output to other businesses for further processing, or to marketing agents who handle the distribution of these products to final consumers or to next-stage users.

Relying on markets in this way can bring important advantages to microenterprises. They can obtain their inputs at lower cost, with more reliable supply and better quality. On the output side, they can reach out to larger and more dynamic markets ready to pay them higher prices for the products and services they are able to supply. By narrowing the range of functions they perform themselves and concentrating on those steps in the production and distribution process they do most efficiently, entrepreneurs can raise incomes for the enterprise and for those who work there.

Achieving this result requires that the enterprise have access to reliable markets that supply them with inputs and where they can sell their products. Business linkages are institutional arrangements that facilitate this process of joining microenterprises with other participants in the market.

Types of Linkage Arrangements

Subcontracting: In this arrangement, a microenterprise might produce a particular component for incorporation by the subcontractor in the finished product; alternatively, the supplier may provide a service to the subcontractor (such as cleaning an office or sewing a shirt).

Franchising: In this case, the microenterprise produces a product or service that it sells directly to a final consumer, following standards and procedures established by the franchisor. Along with the rules, the franchisor offers counseling and guidance to the supplier.

Flexible Specialization Networks: In such arrangements, several micro or small enterprises each specialize in one part of a complex, multistage production process. The different participants are linked through arms-length, market transactions.

Brokerage Arrangements: One enterprise handles input procurement, product design, production, and marketing without having any production facilities of its own.

Microenterprises could perform the role of broker; alternatively, the broker could provide a mechanism for linking specialized microenterprises with more complex and dynamic market systems.

When Can Market Linkage Arrangements Work?

These different types of market linkage arrangements have different requirements, particularly in terms of skills, for microenterprises that participate in them. They also have different advantages and disadvantages for the participants, deriving primarily from different market structures. Finally, different types of arrangements may be better suited to different sectors or activities.

Subcontracting has most often arisen where there is a limited range of standardized products or services that can be bought from specialized suppliers.

Franchising is particularly appropriate when small entrepreneurs are relatively inexperienced, and can draw large benefits from the ongoing mentoring that this arrangement provides. Flexible specialization is at the opposite end of the spectrum in this regard, since it presumes the existence of relatively innovative and highly skilled entrepreneurs and workers.

Brokerage arrangements, like subcontracting systems, can make their biggest contribution when there are some entrepreneurs who understand the total market for a particular product group while others are strong on the production side but less capable in product design or marketing skills.

All of these arrangements raise questions about the distribution of benefits among different participants in the system. In general, market power seems to be most unequal in the case of franchises and most equal for flexible specialization, with the other two options falling in between. Things can be done to help move toward a fairer distribution of benefits. One can work toward "multilateralism on both sides" (in other words, having several suppliers, several buyers); one can share information about returns on both sides, providing a context for the contracting process; or one can provide a "court of appeals" for mediating contract disputes.

Examples of these different types of arrangements are emerging as a reflection of market forces at work in the world today; these are relatively efficient ways of doing business. To the extent that they understand and work with those market forces, projects that facilitate and speed the spread of such forces can be a cost-effective way of providing assistance to micro and small enterprises.

Source: For further details, see D.C. Mead, "Linkages within the Private Sector: A Review of Current Thinking," ILO/FIT Working Paper No. 3, March 1994.

USAID

Microenterprise Development Brief
Number 24
September 1995

How Do Women Fare in the Microenterprise Sector?

Over the past several years, significant gender differences in the patterns of micro and small enterprise (MSE) growth have been identified. Through USAID's Microenterprise Development Office's Growth and Equity through Microenterprise Investments and Institutions (GEMINI) Project, surveys have been conducted in Zimbabwe, Swaziland, Botswana, Kenya, Lesotho, Malawi, and the Dominican Republic. This Brief gives an overview of these findings, including a description of typical female-owned businesses; gender evidence on new starts, closures, and expansions; the relationship between the macroeconomy and gender-differentiated growth; and a discussion of the implications of these findings for MSE programs and policies.

MSEs headed by females are numerous, often in the majority, but typically tend to be concentrated in a few low-return, home-based activities.

- At least 45 percent of MSEs in each country surveyed are headed by females, and in four of the seven countries, the majority are owned by women.
- Women's enterprises are concentrated and dominant in more traditional manufacturing activities such as beer brewing, knitting, dressmaking, crocheting, and grass and cane work, as well as in retail trading.
- Returns to female-dominated activities are lower than the average for the sector.
- Nearly half (45 percent) of the female-headed MSEs are home-based, while only 19 percent of the male-headed MSEs operate from the home.

New start rates are higher for MSEs headed by females than for those headed by males.

- Female-owned MSEs show annual start rates more than 5 percentage points higher than the male rate, a pattern that holds in each country examined.
- One possible explanation for higher start rates centers on the nature of the sectoral concentration of female-headed enterprises. In Zimbabwe, for example, the five sectors with the highest percentage of women entrepreneurs had the lowest capital- and skill-entry barriers.

Closure rates are also higher for female- than for male-headed MSEs, but only when all reasons for closing are considered.

- Once personal reasons for business closure are excluded (such as childbirth or family relocation), female-run businesses are no less likely to close than their male counterparts.

- In the Dominican Republic, annual closure rates for enterprises run by females were more than three times those for male-headed MSEs.

Female-headed MSEs grow less rapidly than those headed by males because, in many cases, they are frequently concentrated in slowly growing sectors (with a few important exceptions).

- Female-headed enterprises in the survey countries[1] grew around 7 percent, while those headed by males grew around 11 percent per year.

- Individual country surveys typically reveal that in many of the sectors where the highest growth rates of existing firms are found, such as construction, transportation, and personal services, female ownership is minimal.

- Enterprises owned by males grow more rapidly (or at the same rate) than those owned by females in the manufacturing, trade, and service sectors of the African countries surveyed, with two exceptions. The two exceptions, trading in Malawi and services in Swaziland, provide an important reminder that MSEs owned by women do not always grow less rapidly than their male counterparts and are not always mired in low growth sectors.

Fewer female-owned MSEs expand or graduate to become small businesses.[2]

- Only 15 percent of the female-headed enterprises expanded in the surveyed countries, while over 23 percent of the male-headed firms grew.

- Although the graduation rate, in general, is low (1.1 percent), the comparable graduation rate for enterprises owned by men is eight times that of female-owned enterprises.

- Women may follow diversification strategies, investing resources in multiple enterprises rather than accumulating them within one business.

Female-headed MSEs exhibit much short-run volatility, and new starts and closure rates of female-headed MSEs are particularly sensitive to changes in the overall economy.

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[4]Excluding Kenya, an outlier with extremely high growth rates for both female and male-headed enterprises.

[5]In this case, graduation is defined as growing from a microenterprise with fewer than 10 workers into a "small" business with 10 or more workers.

- A Jamaica panel survey reveals that female-owned MSEs experience much more quarter to quarter volatility than those owned by males.

Although perceived main problems are similar by gender, inadequate market demand is the most often-cited problem of female entrepreneurs.

- The primary problem cited by female entrepreneurs is inadequate market demand, closely followed by lack of access to raw materials and intermediate inputs.
- Men complain somewhat more about their access to fixed and working capital, their access to tools and equipment, and constraints arising from government regulations.

Implications for Programming

- There are large numbers of potential female clients of MSE programs, but many have been overlooked because they are home-based.
- MSE programs must be aggressive in identifying and approaching female clients by actively seeking them out.
- Careful consideration should be given to the types of interventions particularly appropriate for nongrowing enterprises.
- For those female entrepreneurs who wish to grow their enterprises, attention must be focused on more lucrative product lines.

Source: "The Dynamic Role of Micro and Small Enterprises in the Development Process," Final Report, Carl Liedholm and Donald Mead, Action Research Program I, GEMINI Project, September 1995.

Microenterprise Development Brief
Number 25
September 1995

Policy Goals, Reform, and Microenterprise Development

Most governments appear to have a broad set of policy goals that apply to business in general and are independent of business size. Some governments supplement these general rules with specific policies and programs aimed at micro and small enterprises (MSEs). Other governments make occasional exceptions to general rules to provide specific benefits to MSEs.

The major goals of most governments are so basic that many people take them for granted. To these individuals, policy means — almost by definition — some specific policy aimed at specific industries or groups of businesses, including groups of small businesses. Most governments share a set of common goals, however, that take precedence over specific or targeted goals pertinent to groups within the economy. These goals include:

A stable fiscal and monetary policy setting resulting in an economy with reasonable interest rates and a reasonable level of inflation.

Reasonable interest rates can be interpreted to mean rates that are in line with world interest rates. Reasonable inflation means low rates of inflation as well as a rate that is steady and predictable. In recent years, inflation rates in the developed countries have been decreasing, with most major countries experiencing rates between 0 and 5 percent. The more successful developing countries have also been bringing rates downward and have been successful in keeping rates reasonably constant over time. Examples of developing countries with good records include Indonesia, Taiwan, Hong Kong, and Malaysia. Germany and Japan have inflation rates close to zero. The United States, England, and France are currently experiencing inflation of only 2 to 3 percent annually.

A system of financial markets that provides incentives to save and efficient mechanisms to channel savings into investments that raise productive capacity over time.

Financial policy should also provide for a safe monetary system and for careful supervision of financial intermediaries.

A competition policy that establishes rules against monopoly and against anticompetitive group behavior that can take place in cartels *(groups of businesses acting together to control output and prices)*.

Cartels, as such, need not be outlawed. Cartels are undesirable when they use their collusive power to lower output and raise prices, but there are many examples of cooperative behavior among firms that falls short of collusion in restraint of trade or competition. Some arrangements allow the sharing of production equipment — for example, when the morning and evening papers in a city share printing presses, but keep all other functions separate. Firms may also join together to share the cost of developing new technology. Most monopolies or cartels that exist over time are created by government legislation and continue to exist only because of continued government tolerance.

A human capital development program that calls for universal basic education and for reasonable access to college education or to advanced vocational training for those with the skills and drive to be successful in these areas.

Skilled workers are a source of entrepreneurial talent needed to produce a flow of successful business start-ups.

An infrastructure development program that provides the communications network, roads, water and sewer systems, and ports needed to facilitate business transactions.

A set of policies that establish a favorable climate for the start-up of new businesses and for the growth of businesses.

Included in this set are policies that minimize the costs of licensing and registering a business, policies that call for the government to provide easy access to information about laws and regulations, and policies such as commercial codes that establish rules to minimize the cost of doing business by defining the rights and responsibilities of all parties to a transaction.

Policies that establish and enforce clear rights to property and clear rules related to the performance of contracts.

Well-defined property rights and good contract law help to minimize the costs of accomplishing both exchange transactions and production transactions. Minimizing transaction costs releases resources that can be used to increase overall welfare.

Most countries appear to have these basic policies in place. Even when some countries establish different policies, they are often attempting to reach the same goals. Germany, for example, takes a different approach to the licensing issue. Rather than making the process simple and inexpensive, the German government, working with trade and craft associations, establishes significant testing requirements and identifies specific skills and knowledge needed to start businesses in various industries. The German government also establishes explicit guidelines covering capital requirements for start-ups in certain industries. The objective here is not to preclude entry, but to ensure that entrants are capable of meeting output standards and of managing an effective business. Such policies work in a country that has invested substantial government resources in vocational education and apprenticeship programs. They would have far different, highly adverse effects on MSEs in countries where such human capital investments have not taken place.

Many other countries have supplemental policies aimed at enabling smaller businesses to survive and to compete more effectively. Many of these policies call for programs to overcome perceived MSE weaknesses in such areas as management or finance. In some countries, such as Ireland, Italy, Spain, Portugal, Greece, and Japan, these policies focus on manufacturing, mining, or crafts. In other countries, such as the United States, Holland, Belgium, Great Britain, and Germany, supplemental policies are targeted at MSEs regardless of industry. In developing countries, most assistance programs are aimed at targeted sectors. Manufacturing receives the most attention, often because MSEs have been selected to help with an export strategy or with an import-substitution strategy.

Some countries use focused policies to nurture the development of an indigenous industry. Brazil, for example, has developed a capable airplane industry that has benefitted from and provided benefits for many Brazilian MSEs. Such highly targeted efforts can produce poor or even negative results, however, and can harm the overall development effort. Brazil had to abandon its attempt to develop an internal computer manufacturing capability. The main loss from the project was not the failure to produce computers, but the loss to Brazilian industry because foreign computers were embargoed for several years.

Other countries may also have difficulties with import-substitution programs because these programs use high tariff barriers or quotas to restrict foreign competition. The domestic industry built behind this wall of protection often features high costs and ultimately proves unable to survive without continued protection from imports. The protective barriers change relative prices, sometimes distorting development patterns and lowering living standards for long periods.

The Asian Tigers, including Hong Kong, Taiwan, South Korea, and Thailand, appear to focus on the ability of selected MSEs to grow and to increase country exports. South Korea uses an extremely narrowly focused program to target several hundred businesses each year for concentrated financial, management, and technical assistance. Assistance is provided by the Industrial Bank of Korea (formerly the Small and Medium Enterprise Bank of Korea), which provides both financial and technical assistance.

The Asian governments are also able to structure incentives that induce MSEs in targeted industries to respond to government plans and targets. Government programs then support those MSEs that respond effectively to the incentive structure created by the government. This process establishes a strong working partnership between selected MSEs and the Asian governments. All of the Asian governments have been successful in creating export surpluses using these techniques.

This targeting strategy is not sustainable in the long run, however, because other governments will take steps to limit import growth, if necessary. The world financial markets will also work against the continued success of such a strategy by putting upward pressure on the currencies of the exporting countries. Japan, for example, which pioneered many of the successful export enhancing programs, is faced with an appreciated yen at this moment that makes Japanese export products more expensive in importing countries.

Source: "Building an Institutional and Policy Framework to Support Small and Medium Enterprises: Learning from Other Cultures," Tom Gray and Matt Gamser, Implementing Policy Change Project, Development Alternatives, Inc., April 1994.

Microenterprise Development Brief
Number 26
September 1995

Institutional Options for Transitional Economies: Four Models for Small Business Policy Making and Program Implementation

At least four general models are used to develop a small enterprise policy by relatively large numbers of governments. First, some governments develop a specialized ministry or bureau as the designated micro and small enterprise (MSE) department. In one variation of this model, the designated MSE bureau is responsible for both policy development and program implementation. An example of this model may be found in the United States Small Business Administration. Even in this "pure" or "focused" model, however, it is unlikely that all national support programs are contained in the central organization. Other ministries or bureaus are likely to house some MSE activity related to their primary mission area. In the United States, for example, export support for MSEs is found in the Export Trade Administration of the Department of Commerce as well as in the International Trade Office of the Small Business Administration.

A second model, also widely dispersed, has a central policy ministry or bureau but has program implementation spread across other government (or in some cases, nongovernment) ministries or bureaus. The Dutch and German governments have specialized MSE subministries located within their respective Ministries for Economic Affairs. Program implementation in Holland and in Germany is accomplished by a variety of ministries, depending on the nature and goals of the program being implemented.

A third model has no central policy ministry charged with responsibility for MSE policy, but does have a ministry charged with implementation of MSE programming. Spain, Portugal, and Greece have no central policy ministry for MSEs, but they each have specialized ministries responsible for implementation of programs aimed at MSEs.

Finally, a fourth model features no central policy ministry for MSEs and no central implementation capability. Both policy development and policy implementation are left to the functional ministries, which develop MSE policy and programming on their own. Examples of this model can be found in Italy, France, Belgium, Luxembourg, Great Britain, and Denmark. Belgium, Luxembourg, and Great Britain form a subclass within this category since each country has two ministries charged with responsibility for some MSE policy and some MSE programming. All three countries also use some other external ministries for MSE programming.

Ireland, strictly speaking, does not fit well in any of the four classes defined above. Ireland does have a locus of MSE policy making within the Ministry for Trade and Industry, but the policy making is restricted to small and medium-sized manufacturing firms only. Ireland has no policy focus and no programming for other, nonmanufacturing MSEs.

Indonesia has a small business policy center within the Ministry for Trade and Industry. Program implementation is spread over other ministries. This would normally put Indonesia in the second class above.

MSE program implementation is coordinated, however, by a senior minister responsible for the 14 ministries that affect the economic life of the country. Under this super ministry, Indonesia would be more like the first model, above.

Korea is another example of a sophisticated small business strategy organized along the lines of the second model. The locus of small business policy is an office within the Ministry of Industry and Trade. From the early 1960s through the mid-1970s, the Korean government followed a general policy of strengthening small businesses through education and training and through the removal of barriers inhibiting small business growth. The government also sponsored some financing through the Small and Medium Enterprise Bank. This bank was later renamed the Industrial Bank of Korea. In addition to financing, the bank provides technical assistance through its own staff of skilled engineers. From the mid-1970s onward, the Korean government focused attention on a relatively small number of medium-sized businesses, providing a combination of services designed to help these businesses become export leaders.

Government structures are heavily influenced by local history, by the manner in which small businesses are organized, and by the specific roles seen for MSEs in the economy. There is no ideal MSE support structure. It seems more important to have good communications among the government bodies responsible for MSE interests at the state and local levels, and a means to bring MSE concerns to the highest levels of policy debate. A Ministry or Bureau for MSEs, although it may help to focus attention on MSE matters, does not, by itself, ensure sound, well-coordinated MSE policy.

Source: "Building an Institutional and Policy Framework to Support Small and Medium Enterprises: Learning from Other Cultures," Tom Gray and Matt Gamser, Implementing Policy Change Project, Development Alternatives, Inc., April 1994.

USAID

Microenterprise Development Brief
Number 27
September 1995

The Institutional Evolution of the Microenterprise Field, 1989-1995

The U.S. Agency for International Development launched its Microenterprise Initiative in June 1994 to give greater priority to this field than ever before. The past six years have demonstrated how significantly microenterprise development work contributes to poverty alleviation, economic development, and democratic systems development around the world. The most outstanding progress has been made in microfinance services. Today, specialized financial institutions serve millions of micro and small enterprise entrepreneurs and poor households in countries such as Indonesia and Bangladesh, Bolivia, Colombia, Ecuador, El Salvador, and the Dominican Republic.

Although first-time client borrowings and savings generally do not exceed a few hundred dollars, these institutions intermediate millions of dollars a month. Several now carry out this financial intermediation so profitably that commercial banks and other licensed financial institutions are starting to compete for their clients. This competition provides the poor with greater choice in services, which can only lead to greater value for these customers.

Institutional development remains at the center of financial services development for the poor, but the institutional issues have changed radically since USAID launched the Growth and Equity through Microenterprise Investments and Institutions (GEMINI) Project in 1989 (see table next page). Then, practitioners talked about *evolving programs*: going from one site to many sites, or going from a multipurpose mission to a more specialized financial services strategy ("minimalism"). Today the central issue is not evolving programs but *evolving institutions*: moving nonbank institutions into the financial system and moving commercial banks into microfinance markets and services.

In 1989, talk was about whether programs could get to a significant *scale* of operation. The geometric growth of the Indonesian rural finance institutions, the ACCION network, and several village banking programs ended such speculation. Today the issue is *how to manage institutions operating at scale*, so that they can sustain rapid growth without overreaching themselves. Six years ago finance program managers strove for *self-sufficiency*, which meant covering operating costs from revenues. Today the goal is *profitability*, so that the institutions can attract investment from local and international capital markets. In 1989, institutions and affiliate networks concentrated on the *standardization* of a few (mostly debt) financial products, and hoped that clients whose needs progressed beyond these products could graduate to other financial institutions. Today the most successful institutions strive to *diversify their products* to keep their best clients in their system.

Leading microfinance institutions in 1989 saw *donor agencies* as their major source of support. Today the field's leaders look to *local and international capital markets.* Then, managers grappled with how to develop systems to *monitor and evaluate* their own performance. Today, with leading institutions taking in substantial local savings and investment capital, the central issue is how to implement effective *external regulation and supervision.*

INSTITUTIONAL ISSUES THEN AND NOW

1989	1995
evolving programs	evolving institutions
achieving scale	management at scale
self-sufficiency	profitability
standardization/graduation	product diversity
donor support	capitalization
monitoring and evaluation	regulation and supervision
documentation	innovation
less-developed countries	transition economies

In 1989, USAID and the new leaders of the GEMINI project sensed that some key lessons had been learned and that their main challenge was to *document* those lessons. The successes of the past six years have shown how far there is yet to go, particularly to enable new financial institutions to survive in the world's increasingly open and competitive financial markets. Recent experience has placed the accent back on *innovation* in financial products and delivery systems.

Finally, the USAID development world has changed radically from 1989 to today. USAID has replaced the Asia-Africa-Latin America *developing country* operating theater with a larger, far more complex sphere of operation, including *transition economies* in Central Europe, the former states of the Soviet Union, southern Africa, and east Asia. We are finding that some of our institutional experience in traditional USAID countries is valuable for the problems confronted in the new countries; but we also find that there are many new issues to address in providing market responsive services in these environments.

We cannot point to similar levels of achievement in nonfinancial services to microenterprises, but we have uncovered some promising path. Focusing more on market demand and less on supply-driven strategies (one type of training for all microenterprises) has led institutions such as CARE, Save the Children, and Appropriate Technology International to radically restructure their programs. Concurrently, we are learning about how to work with different types of institutions, particularly institutions owned and controlled by microenterprise entrepreneurs, which may provide more cost-effective means for delivering firm-level services.

USAID

Microenterprise Development Brief
Number 28
September 1995

Business Associations and Microenterprise Development

Business associations of various types can be useful conduits for microenterprise development assistance. They offer a means to channel aid to large numbers of firms through an organization that understands their needs and reach out to them efficiently and effectively. Creating an organized voice for micro and small enterprises (MSEs) is a necessary step to solidifying the transition to more market-oriented economies and to more democratic policy making. Business associations can also be instrumental in promoting cooperation between microenterprises and larger firms to open up new market opportunities.

There are many ways of organizing the business community, some of which are more useful to microenterprise interests than others.

In most cases, voluntary associations will be more useful to micro and small enterprises than compulsory membership bodies.

Certain developed countries, such as Germany, use compulsory-membership business associations (such as chambers of trade, the *Berufskammern*) effectively. They can do so because this compulsory structure is linked to an extensive, government-subsidized system of basic training and development. Membership, although compulsory, must be earned, and the stamp of professional approval it carries translates into jobs and markets. The government's investment creates clear market incentives for association through its structures.

Few, if any, developing countries or transition economy countries provide the same environment or incentives to make compulsory business bodies work effectively. This model has its problems even in other West European countries, largely because all-size business or trade associations do not always represent smaller firm interests well. In Italy, all businesses, large and small, must join the government-sponsored chamber of commerce. Small and medium-sized enterprises, dissatisfied with this chamber's work, have formed a parallel, private organization; this organization now has almost as many members as the government’s chamber, although no firm is required to join and all still have to pay dues to the government body.

Compulsory membership associations are a particularly bad idea — and should be discouraged by donors — in countries making a transition from central planning to more market-oriented political and economic systems. These countries all maintained compulsory membership business associations throughout their previous regimes. These compulsory bodies served as instruments of control, not as representatives of business interests. Therefore it is critical, as a part of solidifying the transition to a market economy, to make a clean break from this mode of organizing business.

In many countries the leadership of these bodies has not yet changed, and establishing compulsory membership in new laws and regulations will entrench this control-oriented cadre. In countries like Poland, Mongolia, and South Africa (which has been as centrally planned as these other economies in virtually every respect), the old chambers and their leaders have been the strongest advocates for mandatory membership and other government-mandated entitlements for their bodies. Even when the leadership has changed, the new leaders need constant reminding of the need to serve their constituents because this service orientation is a completely new concept for association leadership. Compulsory membership, which brings dues regardless of service, discourages the new leaders from changing this orientation.

> The Mongolia Chamber of Commerce and Industry (MCCI) has broken away from the Ministry of Industry and Trade that once contained it (and mandated membership in it), which has forced MCCI to seek out new member service activities to sustain its operations. This is a difficult task for a leadership who have known only the Communist system, but the struggle is a healthy one for the development of the country's private sector. MCCI is setting an example for other business groups as it sets up business service centers, business directories, and other fee-for-service operations to attract new members.

General business associations, such as chambers of commerce, are unlikely to provide a sufficient voice for MSE interests because they tend to be dominated by larger firms. The challenge is to create or support institutions that can represent MSE interests. These institutions can be organized geographically or by trade group.

Many small business organizations are founded because industry or trade associations, or local chambers of commerce, do not provide adequate attention to their specific problems. Often a cluster of larger businesses captures control of the association because they have greater resources to commit to its activities. Even when local chambers of commerce concentrate on the concerns of smaller firms, as in the U.S. local chambers of commerce, their national bodies (such as the U.S. Chamber of Commerce) tend to represent large business interests.

This situation has led small businesses in many developed countries to form alternative national organizations to represent their points of view. These alternative associations have both general business structures (such as the National Federation of Independent Businesses in the United States, the Confédération Générale des Petites et Moyennes Entreprises in France, and the Confederacion Espagnol de la Pequena y Mediana Empresa in Spain) and trade structures (such as the National Small Business United and the Small Business Legislative Council in the United States, and the Confédération Nationale de l'Artisanat et des Métiers in France). When general business associations exist, the governments seem to pay more attention to broad small business issues. When more specific trade-focused bodies represent MSE interests, less government attention seems to be paid to broad small business policy issues and more attention to specific policies or technical issues

. **Organizing MSEs is no easy task: aside from wanting lower taxes (or no taxes), there is perhaps no single policy issue on which all MSEs will agree.**

MSEs are independent in spirit and are almost always closely held (one individual or family owner). Many entrepreneurs went into business because they did not want to take instructions from someone else. Thus, there are few issues on which small businesses will be united, except for tax policy (all want lower taxes), and in this case the small business position is the same as the big business position.

MSE associations often are unable to attract more than a small fraction of firms in their areas to become members because many firms prefer to be free riders, enjoying the benefits of policy reform without the costs of membership. Cash-flow-constrained, short-term-focused smaller enterprises are far more prone to the free rider temptation than larger firms.

Another problem in organizing MSEs is the large transaction costs of communicating to any group made up of many small members. The problem is complicated by the dynamic nature of smaller firms, which go in and out of business, change location, and even change markets frequently. Organizing larger firms is comparatively simple, because most, if not all, are registered and relatively stable (in location, number of employees, and so forth), and thus much easier to find.

For these reasons, MSE associations must provide services other than just advocacy to attract and keep members. It is useful to select services that provide a real and immediate return to members and to the association (in fees for services).

Lobbying, or advocacy for MSE interests, is only one service an association can provide. Although policy and regulatory problems are one of the strongest initial motivators for bringing small firms together, they do not, in most cases, provide sufficient motivation to keep them together. Policy reform usually requires a heavy up-front investment and a long wait for returns. This is particularly hard for cash-poor small firms to swallow.

Most successful associations in developed countries have introduced other services including information provision, training, technical certification (particularly for trade associations), insurance services, input supply, and marketing or brokerage operations to complement their lobbying efforts in attracting and keeping members. Many small business associations in Asia, Africa, and Latin America have also followed this route.

> INSOTEC in Ecuador has helped CENTRIMA, a leather products producers' association, establish an input supply service for its members. It has assisted other artisan associations in setting up credit unions and technical training programs, all of which help to support the other organizing and advocacy work of these bodies. The Chamber of Commerce, Industry and Trade in Burkina Faso owns hotels and gasoline stations, which are heavily used by its members (and by the general public).

Associations in Central Europe, the former Soviet Union, and other former Communist regimes have more adjustments to make in this area. The Chamber of Commerce and Industry in Mongolia, for example, has carried over services from the Communist regime, such as the issue of patents, but these are noncompetitive services with limited application in the new, trade-dominated private sector. The Growth and Equity through Investments and Institutions (GEMINI) Project has helped the Mongolia Chamber of Commerce and Industry to pursue other, more immediately useful, services such as basic business assistance in communications and promotional materials preparation (for local and foreign firms), arbitration and other alternative forms of dispute resolution (to the overextended court system), and trade promotion tours.

GEMINI helped the Mongolian Union of Producer and Service Cooperatives publish the first membership directory ever seen in the country, a Yellow Pages type of operation with potential for considerable revenue generation. The notion that one has to hustle for members and client business is difficult for the association leaders to understand, because private business itself is a new phenomenon in the country. Unless the associations can learn to be service businesses themselves, however, they will not survive after the government cuts their purse strings.

The one potential pitfall for associations expanding services other than advocacy is that, if carried to extreme, this policy can take the body away from the interests of its members. In Burkina Faso, the Chamber of Commerce seems far more interested in maximizing profits from its hotels and gas stations than in reaching out to address the problems of overregulation of the country's artisans. However, most MSE associations fall short in the other direction, with too much time devoted to longer-term advocacy pursuits and too little to services to address members' immediate needs.

> *In sum, business associations can play a key role in MSE development, but whether they will do so depends on how they are encouraged to develop and grow themselves. Independent associations with stronger member-service orientations and with a strong commitment to MSE interests (either because they are MSE-controlled organizations or because they are structured to provide a voice to MSE interests) are more likely to play a useful role than government-sponsored, compulsory membership bodies. Associations that offer a mixture of advocacy and other, more immediate-impact services are more likely to be sustainable and, therefore, of long-term value to the MSE community.*

Further Reading

"Building an Institutional and Policy Framework to Support Small and Medium Enterprises: Learning from Other Cultures," Tom Gray and Matt Gamser, Implementing Policy Change Project, Development Alternatives, Inc., April 1994.

The following GEMINI publications are available through PACT Publications, 777 United Nations Plaza, New York, NY 10017, phone: (212) 697-6222, fax: (212) 692-9748.

"Private Business Organizations and the Legislative Process," Tom Gray, GEMINI Working Paper No. 40, July 1993.

"Toward More Cost-effective Nonfinancial Assistance: Case Studies in Subsector-based MSE Development," Mohini Malhotra and Jennifer Santer, GEMINI Working Paper No. 49, October 1994.

"The Private Operators' Perspective on an Agenda for Action," Dakar, Senegal, November 22-25, 1991. A Seminar on the Private Sector in West Africa, GEMINI Technical Report No. 37, May 1992.

"New Competitiveness and New Enterprises in Peru: Small Businesses in an Internationalized Economy," Fidel Castro Zambrano and Ernesto Kritz, GEMINI Technical Report No. 61, August 1993.

"Private Sector Business Associations in South Africa and Zambia: Advocacy for SMEs," Kenneth Angell, GEMINI Technical Report No. 69, March 1994.

"Summary Report on the Polish Delegation's Tour of Small Business Assistance Organizations in the United States," Adam P. Saffer, GEMINI Technical Report No. 78, September 1994.

"Mongolian Chamber of Commerce and Industry Study Tour: U.S. Business Associations and Services," Tom Gray, GEMINI Technical Report No. 79, September 1994.

USAID

Microenterprise Development Brief
Number 29
September 1995

State-Owned Agricultural Development Banks: An Untapped Infrastructure for Microfinance?

This Brief examines the potential role of state-owned agricultural development banks as a source of microfinance services. It discusses preconditions for success in restructuring these banks and elements of the ideal framework for the transformation. Historically, agricultural development banks have been unsuccessful in reaching the poor and have lacked financial viability. Many have become insolvent and required additional capital to continue operations. Eventually, they lost donor support and fell prey to political interests. Despite these problems, agricultural development banks are again being considered potential institutions for the delivery of microfinance services, particularly in rural areas. Proponents hope to harness the personnel and physical infrastructure to serve the poorest, rather than creating specialized microfinance institutions. Can agricultural development banks fill this purpose?

Preconditions for Success

Given basic flaws revealed by their history, only a few state-owned agricultural development banks may be viable candidates for successful restructuring. Success depends on a strong combination of several preconditions. The bank must operate in a country with at least a moderate degree of macroeconomic equilibrium and a sound fiscal system committed to financial reform. The bank should have or be developing an effective framework for prudential regulation and supervision and a dynamic agricultural sector. The bank should have access to legal recourse to enforce financial contracts. Its portfolio should not have a high rate of default (for example, nonperforming loans should amount to no more than 20 percent of the total), and past default problems should not bethe result of staff incompetence or corruption.

The bank should also have a management information system in place or be able to install one rapidly to track portfolio quality.

How Should a Restructured Agricultural Development Bank Look?

This question is necessarily influenced by the political and institutional environment in which the bank operates. The following list represents ideal structural features and operating and organizational procedures and practices. Experience suggests that the most successful restructuring attempts have been made during times of crisis for the organization.

Deposit Mobilization. The main source of new funds should be a strong local deposit base. The bank should offer a wide range of deposit facilities throughout its branch network to support growing lending. This reduces the bank's dependency on outside donors and cultivates new attitudes to risk management.

Capitalization. Initial recapitalization by the government (if necessary) should be followed by additions to capital limited to retained earnings and sales of public shares to the public. The expectation of no future bailouts should be credible, and appropriate capital adequacy requirements should reflect the particular property rights structure of the organization.

Independence. Defense against political intrusion is critical, especially from the Ministry of Agriculture, which always seems to be concerned with loan targeting and seldom with promoting viable lending organizations. Any official appointed to the board of directors should be from the Ministry of Finance or the Central Bank. Exemption from usury laws and other interest rate controls is also required; in particular, the bank should benefit fully from the deregulated environment created by financial reform. Policy changes away from interest rate subsidies may actually reduce political pressures on the bank.

Incentive of Compatible Governance. A board of directors must be appointed in which no government official is the chairman. Private and public sector nominees may serve on this board, but independent private sector members (with reputations to protect) should be in clear majority, with strict conditions for their removal and preferably long terms of service. Board members should be chosen for their technical qualifications rather than as representatives of vested interest groups. Clear criteria and mechanisms of enforcement of their accountability for the bank's performance are needed as well.

Safe and Diversified Portfolio. Emphasis on portfolio diversification would suggest that in rural areas nonfarm enterprises would be as important as farmers. Explicit targeting of uses of loan funds would be avoided, but appropriate monitoring of changes in credit-worthiness would be undertaken. Screening would emphasize expected returns under risky scenarios. Commercial short-term overdraft facilities should be incorporated in the bank's portfolio to balance medium-term lending, along with remunerative treasury bills. This asset composition would give the institution the means to manage both risk and liquidity properly.

Decentralization. Branches should be brought as close to the clientele as possible. Decentralized decision making should rule loan allocation at the branch level, and the transaction costs of borrowers and depositors should be minimized. Remuneration based on such performance-based criteria as profits, number of loans, loan recovery, and deposit mobilization would create compatible incentives for branch staff and management. Transfer pricing would be required to reward deposit mobilization where and when it exceeds local loan demand. Credit rating indicators for a borrower should be available to any branch in the bank.

Human Resource Policies. The organization should enjoy freedom to hire and fire employees and to set wages free from civil service regulations, and to offer performance incentives rather than pay rigid wages based on seniority.

Transparency. State-owned agencies, especially financial institutions, should be at the forefront of disclosure. Accountability should include quarterly and independently audited reports, issued to the public, specifying financial conditions truly and fairly. Such reports should include adjusted balance sheets, income statements, sources and uses of funds, and additional data showing the aging of loan arrears, write-offs, accumulation of reserves, and the market value to the investment portfolio. Similar and more detailed information should be available to the prudential supervisor.

Financial Performance. Performance measures should figure prominently in all financial reports. Income should be realized in cash only, excluding accruals, given the uncertainty of obtaining payment of interest in arrears. However, expenses should report accruals because these represent actual obligations to be fulfilled. Statements of loan and other policies, particularly those relating to loans on which payments are not received in full and on time, should be included in annual reports. Any events having material impact on the bank's financial condition should be announced.

Donor Support. Donors should not fund loans to the organization but should build up its human capital to manage credit risk intelligently. Training, technical assistance, and judicious support for computerization are appropriate donor interventions. Some of the institution's own funds should be committed to these endeavors as well, to ensure continued investment in management information systems upon donor withdrawal. Any donor intervention should not create subsidy dependency, as is the case with support for operating expenses; instead, donor interventions should mainly capitalize the organization. Loan funds may eventually be used, nevertheless, but perverse incentives against deposit mobilization should be avoided.

Source: Excerpted from "State-owned Agricultural Development Banks: Lessons and Opportunities for Microfinance," Claudio Gonzalez-Vega and Douglas Graham, Ohio State University Economics and Sociology Occasional Paper No. 2245, September 1995.

Prepared by the Growth and Equity through Microenterprise Investments and Institutions Project
for the Bureau for Global Programs, Economic Growth Center, Office of Microenterprise Development,
SA-2, Room 300, Washington, D.C. 20523-0230, Tel.: (202) 663-2360, Fax: (202) 663-2708

Microenterprise Development Brief
Number 30
September 1995

CREDIT UNIONS
A Formal Sector Alternative for Financing Microenterprise Development in Developing Countries

Credit unions operate around the developing world, with membership in the millions and known savings of some $8 billion. They are owned and operated by their members, who are also their clients. Typically, credit unions provide the basic set of financial services valued by low income members who lack access to formal sector alternatives, including savings and short-term credit. Credit unions depend on locally generated funds and have low-risk portfolios. So why have they not become the preeminent institution in providing financial services to informal sector entrepreneurs? This issues paper explores this question.

Services

Savings and short-term installment credit are the principal services offered by credit unions. The savings relationship is the first entered into by a member and is key to accessing nonsavings services. A certain level of savings is required before the member can take a loan, which is often at below-market interest rates.

Funding Sources

Credit unions operate on self-generated funds, of which share savings is the primary source. Credit unions are rarely dependent on operating subsidies or subsidized capital.

Risk Management Methods

Credit unions have several techniques for minimizing risk. First, association-based membership gives credit unions greater knowledge of borrowers and allows the use of group pressure to induce repayment. Second, requiring regular savings before borrowing and tying loans to the savings amount reduce the risk from any individual borrower. Finally, by lending for a variety of purposes, risks associated with specializing in particular activities are reduced.

Major Weaknesses of Credit Unions for Microenterprise Lending

- Credit unions tend to be small, limiting their ability to expand activities and assume the risks associated with developing or implementing special programs designed to reach large numbers of microenterprises.

- The tendency to favor low-interest loans over high returns on savings keeps credit unions from generating capital rapidly enough to meet member loan demand and creates liquidity problems.

- Credit unions tend to be conservative and highly traditional. They do not have growth-oriented or service-oriented philosophies. Credit unions have not aggressively pursued membership, nor have they been leaders in developing new savings or loan programs.

- Internal policies and operating procedures such as delinquency control, portfolio management, and internal management information systems must be improved.

The Future Role of Credit Unions in Microenterprise Lending

First, credit unions need not only to maintain but also to upgrade their traditional role, which will require some changes. Credit unions should:

- Improve marketing capabilities; identify their market niche and build on competitive advantages;

- Develop modern, innovative financial services (both savings and loan) that meet a broader spectrum of member needs, including those of microenterprise owners;

- Improve internal operations and procedures and develop the growth mentality of modern financial institutions; and

- Improve supervision, regulation, and monitoring to ensure safety of member funds.

Second, credit unions can fill current gaps in financial services for microenterprises:

- Current specialized microenterprise programs may be able to graduate their clients into formal membership in credit unions. This is a market unlikely to be served by banks, which generally do not view small savers and borrowers as attractive clients.

- Credit unions could actively pursue microenterprise program clients as members. The credit unions would provide savings and loan services, while the specialized programs would provide complementary training and technical assistance.

Source: *The New World of Microenterprise Finance: Building Healthy Financial Institutions for the Poor* (Chapter Eight by John Magill), edited by Maria Otero and Elisabeth Rhyne, West Hartford, Connecticut: Kumarian Press, Inc., 630 Oakwood Ave., West Hartford, CT 06110, USA, 1994. To order, call toll free: 1-800-289-2664.

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Microenterprise Development Brief
Number 31
September 1995

Controlling Delinquency

The failure to control loan delinquency, which often leads to default, is probably the largest single downfall of institutions that provide credit to microenterprise entrepreneurs; the risk of delinquency and default must be continually addressed. Most commonly, loans are considered delinquent or past due when two payments have been missed. A lending institution's largest asset is its loan portfolio, the total amount (of principal) owed by borrowers. The portfolio generates income in interest and fees. Because a lending institution cannot always be sure that it will get its money back, the loan portfolio is always at risk to some extent. Protecting the portfolio allows the institution to continue to provide credit services to microenterprise entrepreneurs. Three measures for the quality, or amount of risk, of loan portfolios are widely used — default rate, repayment rate, and delinquency rate. These terms mean nothing if everyone calculates them differently. The following definitions and formulas have been tested and proved in commercial banking, and are the most helpful in providing timely information to microfinance program managers. Each has a different purpose or use and tells us something different about the portfolio.

Definitions and Formulas

Default Rate measures the amount the institution has declared nonrecoverable as a percentage of the portfolio (also referred to as loan loss rate). This is the part of the portfolio that can no longer generate income.

$$\frac{\text{amount declared nonrecoverable in period}}{\text{average portfolio in period}}$$

Repayment Rate measures the amount of payments received with respect to the amount due. It does not measure portfolio quality or risk.

$$\frac{\text{amount received in period}}{\text{amount due in period + amount past due}}$$

Delinquency Rate measures the percentage of a loan portfolio at risk. The entire balance of a loan is considered at risk when any portion of the loan principal is past due. The percentage should be broken down by age, such as the percentage with payments past due 31-60 days, 61-90 days, and more than 90 days, to determine the level of risk.

$$\frac{\text{balance of loans with payments past due}}{\text{total amount outstanding}}$$

Costs of Delinquency

Delinquency affects a program in both measurable and unmeasurable ways:

- Postponed or lost income;
- Slower portfolio rotation, which lowers asset productivity;
- Lower staff morale;
- Higher costs of fighting delinquency;
- Diminished program image;
- Higher likelihood of default; and
- Increased cost of loan loss reserve.

Preventing Delinquency

It is easier to prevent delinquency than to cure it. Methods for preventing delinquency depend on the context. In general, they are grouped into three critical areas:

Image and Philosophy. Microenterprise lending programs should differentiate themselves from the "give-away type of development programs that may be familiar to microentrepreneurs" and "create an institutional culture in which late payments are simply unacceptable" (Stearns, GEMINI Technical Note No. 1).

Methodology. Three aspects of credit methodology help limit delinquency:

- ***Borrower Selection***. Guard against giving bad loans to respond to slow demand. Group loans and character-based loans are effective mechanisms for selecting trustworthy borrowers.

- ***Loan Sizes and Terms*** should be geared to the borrower's repayment capacity. Base decisions on current capacity to repay rather than on projections.

- ***Incentives to Repay***. Poor incentive structure encourages poor payment. The lending institution must make it worthwhile for borrowers to repay on time. Possible incentives for timely repayment include larger follow-up loans, penalty fees for late payments, and potential legal problems for not paying.

Information Systems that help field staff follow up with their borrowers and management analyze the portfolio, preferably on a daily basis.

Curing Delinquency

Curing delinquency is extremely difficult but can be accomplished by examining and changing the institution's image, philosophy, and methodology. The examination should lead to the identification of trends. For example:

- If certain activities are more delinquent than others, loan sizes and terms may be wrong for these activities.

- A high delinquency rate for a certain loan officer suggests poor performance, insufficient training, or possibly fraud.

- If loans made during a specific month are more delinquent (for example, before a major holiday), the institution may consider not making loans in that month.

New loans are not a solution to a delinquency crisis, but loans to borrowers who pay on time can continue.

Rescheduling and Refinancing

Rescheduling and refinancing should never be considered a cure for delinquency or a primary tool for controlling it. Rescheduling and refinancing serve only as a short-term solution and may not reduce the risk of the portfolio. In fact, they may encourage delinquency because both reward the borrower for falling behind. These methods should be used only as a last resort in justified cases when well-meaning borrowers cannot pay.

Source: Excerpted from "Methods for Managing Delinquency," Katherine Stearns, GEMINI Technical Note No. 1, April 1991.

Microenterprise Development Brief
Number 32
September 1995

Evaluating Microenterprise Finance Programs

Evaluation is a key ingredient in assessing the success of microenterprise finance programs and in identifying ways in which ongoing programs can be improved. Evaluations should be carried out at two broad levels: at the client level and at the institutional level. Below are brief pointers about topics that should be addressed in evaluating microenterprise finance programs.

The Client Service Perspective

There are three ways in which programs can be evaluated from a client service perspective:

1. Evaluate program clientele.
    - How many potential clients are there?
    - What are their basic characteristics?
    - What are their needs, preferences, and financial service alternatives?
    - What types of clients want what specific services and products?
    - Which customers are "good"?

2. Evaluate quality of service.
    - Are clients willing to pay full cost for services?
    - What specific service features do clients want (such as loan sizes, maturity, collateral requirements, grace periods, group guarantees, and liquidity of deposits)?
    - What are the transaction costs borne by clients, both out of pocket and cost of time?
    - What is the length of time between application and disbursement of loans?
    - What are the costs and features of services as compared with alternative sources of financial services?

3. Evaluate the impact on clients' choices and quality of life.
    - How has availability of this source of finance changed clients' business and personal financial decisions?
    - What options are now open to clients that were not present before?
    - What do clients do differently now that they could not do without the service?
    - What were the direct uses made of the services, and how were those actions undertaken before the services were available?

The Institutional Perspective

1. Evaluate institutional self-sufficiency.

    - Is the institution profitable?
    - How good is the credit portfolio quality?
    - How does the program's performance measure up to that of industry peers?

2. Evaluate institutional economic condition

    - How profitable is the institution? This can be measured as excess income over expenses, both absolutely and in return on equity.
    - What is the exposure to risk of default? This can be based on delinquency rates and nonperforming assets.
    - What liquidity risks does the institution face in terms of interruptions of lending caused by lack of funds or an inability to meet demands for deposit withdrawals? This can be measured by percentage of total assets held in liquid form.
    - What is the capital adequacy level, or equity as a percentage of total assets? The higher the capital adequacy ratio, the more owners' assets are at risk and the more responsibly they will manage the institution.

3. Evaluate institutional strength and context.

    - Does the institution demonstrate an ability to maintain and build on past achievements?
    - What are internal characteristics of the institution, such as leadership, vision, management, information flow, staff turnover, policy making, and internal oversight?
    - What are external characteristics of the institution, such as the image of the institution among clients, the business community, and political leaders?
    - What are the potential impacts on the institution of political forces and regulatory issues?

Evaluations of finance programs based on the two-level framework described here provide a clear picture of program achievements and a useful market and service analysis for the assisted financial institution.

Source: *The New World of Microenterprise Finance: Building Healthy Financial Institutions for the Poor* (Chapter Six by Elisabeth Rhyne), edited by Maria Otero and Elisabeth Rhyne, West Hartford, Connecticut: Kumarian Press, Inc., 630 Oakwood Ave., West Hartford, CT 06110, USA, 1994. To order, call toll free: 1-800-289-2664.

Microenterprise Development Brief
Number 33 November, 1995

GRAMEEN BANK'S SIXTEEN DECISIONS

Grameen Bank's 16 Decisions are an example of a social development program melded with microcredit delivery. They were developed in a 1984 workshop of Grameen Bank members representing 100 centers, and have been an integral part of Grameen Bank's mission ever since. Because these decisions are of general interest among microenterprise finance practitioners, USAID is reproducing them in this note. The decisions are:

1. The four principles of the Grameen Bank - Discipline, Unity, Courage and Hard Work - we shall follow and advance in all walks of our lives.

2. Prosperity we shall bring to our families.

3. We shall not live in dilapidated houses. We shall repair our houses and work towards constructing new houses at the earliest.

4. We shall grow vegetables all the year around. We shall eat plenty of them and sell the surplus.

5. During the planting seasons, we shall plant as many seedlings as possible.

6. We shall plan to keep our families small. We shall minimize our expenditures. We shall look after our health.

7. We shall educate our children and ensure that they can earn to pay for their education.

8. We shall always keep our children and the environment clean.

9. We shall build and use pit-latrines.

10. We shall drink tube-well water. If it is not available, we shall boil water or use alum.

11. We shall not take any dowry in our sons' weddings, neither shall we give any dowry in our daughters' weddings. We shall keep the center free from the curse of dowry. We shall not practice child marriage.

12. We shall not inflict any injustice on anyone, neither shall we allow anyone to do so.

13. For higher income, we shall collectively undertake bigger investments.

14. We shall always be ready to help each other. If anyone is in difficulty, we shall all help them.

15. If we come to know of any breach of discipline in any center, we shall al go there and help restore discipline.

16. We shall introduce physical exercise in all our centers. We shall take part in all social activities collectively

Prospective members study the 16 Decisions and are tested on them before being accepted as members. Most center meetings include recitation of some of the 16 Decisions. Special social programs designed by Grameen Bank may be implemented, often primarily by the members themselves, to support members in following the decisions. For example, Grameen Bank has been involved in vegetable seed distribution and in setting up schools. Such programs are not part of the core credit operations, and to the extent that they require additional costs, are usually funded separately from the credit operation.

Comment: The 16 Decisions are a social development agenda that places primary responsibility on members rather than on Grameen Bank for implementation. They are closely tailored to the setting of rural Bangladesh. Importantly, they do not add to the cost of the credit operations.

Source: Susan Holcombe, Managing to Empower: The Grameen Bank's Experience of Poverty Alleviation, Zed Books: London: 1995.

United States Agency for International Development
Microenterprise Development Brief
Number 34 October 1996

USAID POLICY ON MICROENTERPRISE DEVELOPMENT

USAID supports microenterprise development to help expand economic opportunity for the many poor people operating or working in microenterprises. This brief summarizes the September 1995 Policy Paper on microenterprise development, now applicable throughout the Agency. The policy seeks to ensure that USAID's support for microenterprise development makes the greatest possible contribution to economic opportunity.

It reflects the core principles of USAID's Microenterprise Initiative:

• a focus on women and the very poor, particularly through poverty lending;

• expansion of outreach to greater numbers of people;

• institutional sustainability and financial self-sufficiency among implementing organizations; and

• improved partnerships with local organizations.

The policy also incorporates key principles of best technical practice.

The Policy Paper specifies requirements which must be met by *all* USAID microenterprise development activities signed after September 30, 1995. These requirements are covered in detail in Automated Directives System (ADS) Chapter 219, and summarized briefly here.

USAID defines a microenterprise as an informally organized business activity which:

• is owned by and employs poor people;

• employs ten or fewer people, including the microentrepreneur and any family workers; and

• is not engaged in crop production.

In many countries, a majority of microentrepreneurs are women who may depend heavily on income from microentrepreneurial activities. Female microentrepreneurs are of special concern to USAID.

USAID works to improve the policy and market environment in which microenterprises operate, and improve the performance and outreach of organizations that directly provide financial services and non-financial assistance to microenterprises.
Most USAID funding for microenterprise development supports the development of viable microfinance institutions (MFIs) offering unsubsidized, high-quality financial services. USAID provides limited support for the development of cost-effective non-financial assistance methods in areas such as training and market development.

Guidance on USAID support for microfinance. USAID may assist a variety of types of institutions: NGOs, microfinance windows of commercial banks, credit unions, etc. In selecting its partners, USAID operating units should mainly consider an MFI's potential to achieve broad outreach (reaching large numbers of poor people) *and/or* deep outreach (reaching the very poor), on an institutionally and financially sustainable basis.

Before any USAID operating unit signs an assistance agreement with any MFI, it must ensure that:

(1) the MFI has full and effective latitude to set interest rates and fees at full-cost-covering levels;

(2) the MFI has established firm control over loan delinquency, with a delinquency rate no higher than 10% (outstanding balance on loans overdue more than 90 days as a percentage of total loan portfolio) and a loss rate below 5% (not applicable to start-up programs); and

(3) the management of the institution has provided USAID with a credible written commitment to attain full financial sustainability on the MFI's financial service activities within no more than seven years of the initial provision of USAID assistance.

This commitment must be accompanied by a plan outlining the major steps to be undertaken to achieving the goal, including a realistic timetable and periodic benchmarks by which progress toward the goal can be determined.

In addition, every agreement for the support of microfinance institutions must require that the assisted MFI provide USAID an annual report of its financial and operational performance and its outreach to the poor, covering a set of indicators specified in the Policy Paper.

As a factor in its disbursement decisions, the USAID operating unit must consider the effort the MFI puts into gathering financial and operational performance data and the extent to which it uses those data in its internal decision making. These requirements apply whether or not an assisted organization regards financial services as the primary focus of its program. The underlying theme behind these requirements is USAID's conviction -- based on clear evidence -- that an MFI must perform effectively *as a financial institution* in order to succeed in reaching large and growing numbers of poor people with vitally needed financial services.

Guidance on USAID support for non-financial assistance and "mixed" programs. Assistance agreements supporting non-financial services for microentrepreneurs should be entered into with the recognition that non-financial assistance methodologies remain somewhat experimental. Agreements must require annual reporting on outreach to the poor as well as financial and operational performance, including the extent of cost recovery and indicators that allow cost-effectiveness to be assessed. Separate reporting on non-financial assistance may be waived when an essentially financial program offers limited non-financial services at little or no additional cost. Otherwise, programs offering both financial and non-financial assistance must meet the requirements applicable to *both* types of programs.

Prepared by Don Sillers, Economist, USAID Bureau for Policy and Program Coordination.

Bureau for Global Programs, Economic Growth Center, Office of Microenterprise Development
1300 Pennsylvania Avenue, NW, Washington, DC 20523 Tel.: (202) 712-5967, Fax: (202) 216-3593
Home page http://www.mip.org

United States Agency for International Development
Microenterprise Development Brief
Number 36   January 1997

MICRO-CREDIT BENEFITS THE CLIENT: EVIDENCE FROM CONTROL GROUP STUDIES

What are the impacts of microenterprise programs? That depends on what you are looking for: enterprise growth or household poverty alleviation; women's empowerment or job creation. Regardless, microenterprise can never be the one magic bullet which will permit the poor to exit poverty. Development is too complex a process for such a single solution. However, the provision of microenterprise services is a key first step. Access to credit and savings services can help the poor to put more food on the table, to protect themselves against crises and to invest in a range of assets. They can increase a person's choices as well as control over these choices.

Many studies of micro-credit programs show how ongoing participation in such programs makes a difference to the clients. However, only a few such studies involve comparison groups of non-participants or first time borrowers, and therefore provide greater confidence in the validity of their findings about the benefits and costs to clients. This note summarizes the results of some of the better control-group studies.

1. Household Income.

In Asia the trend is generally positive, while for Africa it is mixed.

Repeat clients of SANASA, Sri Lanka, experienced a 16% increase in household compared with new entrants into the program. In Bangladesh access to credit enabled TRDEP clients to improve their incomes, with a number graduating out of poverty; BRAC clients, who are poorer, remained below the poverty line, but were able to diversify their income sources and protect themselves better against risk.

Over three years PRIDE borrowers in Guinea who had received multiple loans experienced greater increases in household incomes that those who had only received one loan. Overall clients of the Malawi Mudzi Fund did not benefit from a significant increase in real household incomes and, for 35% of them, incomes declined. Compared with a control group of new borrowers the incomes of ISP clients in Kenya rose while those of KREP borrowers were negative. However expenditure levels for the clients of both organizations increased: KREP and ISP customers experienced rises in levels of household expenditure of 33% and 25% respectively.

2. Enterprise Growth

Revenue growth is a significant impact of access to credit, particularly among repeat clients.

In South Africa monthly profits of the Get Ahead Foundation's clients rose by 80% compared with 43% for a control group. Similar increases in enterprise income were noted among repeat borrowers of PRIDE and both BRAC and TRDEP in Bangladesh. Net monthly incomes also grew for clients of PRODEM in Ecuador and BancoSol in Bolivia.

Sales for both KREP and ISP supported microenterprises grew relative to the control group, the former by 43%, the latter by 25%. A similar conclusion was reached for clients of the Malawi Mudzi Fund and ACEP in Senegal.

Employment generation is mixed.

An assessment of clients of two Indian rural regional banks indicated an average increase in employment of 0.6 workers per enterprise. This was higher for female customers. An 8% growth in paid employment among SANASA clients resulted primarily in jobs for household members. In Bolivia employment generation was higher for borrowers than for the control group. An impact assessment of KIK/KMKP in Indonesia cautioned against drawing conclusions across sectors; it noted positive effects for the industrial and agricultural sectors but negative ones for construction.

3. Food Consumption.

Comparing the multiple loan recipients of PRIDE with non-clients indicated that the borrowers had improved their family diet and increased their consumption of meat or fish. A comparison of Freedom from Hunger's clients in Thailand with a control group indicated a better household diet and increased expenditure on food.

Data for Bangladesh showed that for Grameen women access to credit has a positive effect on household food expenditure and total expenditure per capita.

4. Education.

Grameen Bank credit had a greater impact on boys schooling than girls. However, for women loan recipients, girls schooling was positively affected: a 1.0 percent increase in credit to women is associated with an increased probability of girl's school enrollment of 3.4 percent.

Trends indicate that participants in PRIDE had fewer children who had never been to school and more children who had gone to or completed secondary school compared with other individuals (66 percent versus 43 percent). Among Malawi Mudzi Fund clients 32% used their profits for food and 10% for school fees.

5. Assets

Investment in household assets is associated with participation in a credit program.

In India and Bangladesh - Grameen and BRAC- the value of total assets among borrowers was higher for recipients of multiple loans than for first time borrowers and grew with successive loans. Furthermore, over time BRAC clients restructure their assets towards more income generating assets, itself indicative of a more secure income base. By contrast, an increase in investment in non-productive assets among SANASA clients was noted.

While overall credit to Grameen members increased their non-land assets to double those of non-participants, there are significant differences in the impacts on women and men. Credit to women members increases the value of women's non-land assets, including jewelry, while credit to men does not.

A greater, though modest, impact on women's ownership of household assets was noted among ACEP clients in Senegal. For Get Ahead clients, an important impact can be seen in the improvement in the living conditions of borrowers versus control groups: more households invested in electricity, indoor plumbing and telephone connections.

6. Women's Empowerment.

Women members of Grameen Bank and BRAC were found to be significantly more empowered than those who had not participated in these programs[1]. 64 percent of Grameen members and 56 percent of BRAC members qualified as empowered compared to 28 percent of non-members. Credit enabled Grameen and BRAC members to increase the cash they earned. Indeed, a 1.0 percent increase in Grameen credit for women was shown to increase women's hours devoted to marketable activities by 0.3 percent.

A strong effect of access to credit had been to raise the self esteem of nearly 79% of the ACEP borrowers. This was more strongly felt by women than men.

The index of empowerment combined eight indicators:

- mobility outside the house;
- economic security;
- ability to make small daily purchases;
- ability to make larger purchases;
- involvement in major household decisions;
- relative freedom from domination and family violence;
- political and legal awareness;
- participation in public protests and campaigning.

7. Family Planning

Rates of contraceptive use among Grameen members in one study were 59 percent and among control group members only 43 percent.

Grameen Bank also had a spread effect on non-program households in the communities where it is located. The average rate of contraceptive use among Grameen "neighbors" was 48 percent.

A different study in Bangladesh found that contraceptive use among married women, 14-50, was 42 percent among credit program participants and 37 percent among non-program participants.

List of Institutions

BancoSol, Bolivia
BRAC (Bangladesh Rural Advancement Committee), Bangladesh
ISP, Kenya
Get Ahead Foundation, South Africa
Grameen Bank, Bangladesh
KIK, Indonesia
KMKP, Indonesia
KREP (Kenya Rural Employment programme), Kenya
Malawi Mudzi Fund, Malawi
ACEP, Senegal
PRODEM, Ecuador
PRIDE, Guinea
TRDEP, Bangladesh
SANASA, Lanka

Prepared by Monique Cohen, Senior Technical Advisor, USAID Office of Microenterprise Development, January 1997

United States Agency for International Development

Microenterprise Development Brief
Number 37   October 1998

Commercial Bank Downscalers in Latin America

Introduction
Traditional commercial banks in Latin America are entering the field of microfinance in greater numbers than ever before. What was once a timid exploration of a new market by a few pioneers has transformed into a more committed entry of over twenty banking institutions and finance companies. In many countries of Latin America, one to three banks or finance companies are either offering microloans or are in the process of planning an entry into the market.[1] The implications are far reaching. Not only is the financial sector landscape in each country changing, but the new exploration and competition are encouraging a new wave of product innovation and a fresh look at operating systems.

This brief report highlights some elements of this relatively new trend. It is anecdotal rather than empirical, as the research on this topic is still young. Most of the views expressed here are based on direct conversations with bankers attending two USAID-sponsored conferences (Washington, D.C., November 1996 and Santiago, Chile, March 1998), and the 1997 report, *Commercial Banks in Microfinance: New Actors in the Microfinance World,* which was based on a survey of bankers at the first of those conferences.[2]

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1 [1] Conventional banks and other regulated finance companies in Latin America and the Caribbean that have a microlending unit include: Banco Económico, Banco Unión, and FASSIL in Bolivia; Banco do Noreste in Brazil; Banco del Estado, Banco Santander and Banco de Desarrollo in Chile; Caja Social in Colombia; Banco de Comercio in Costa Rica; Banco Solidario in Ecuador; Banco Agrícola Comercial and Banco de Desarrollo in El Salvador; Banco Empresarial in Guatemala; Bank of Nova Scotia in Guyana; Bank de L'Union Haitienne and Banque InterContinentale in Haiti; Banco de Comercio and Financiera Industrial y Agropecuaria (FIA) in Honduras; Banco del Café, Interbank and Banco del Campo in Nicaragua (using "brokers"); Banco Wiese in Peru; Multicredit Bank in Panama; Financiera Familiar in Paraguay; Bangente in Venezuela. There may be others.

Specialized microfinance banks or financieras, dedicated exclusively to microfinance, include: BancoSol, Caja Los Andes and Fomento de Iniciativas Económicas (FIE) in Bolivia; Finamérica in Colombia; Financiera Calpiá in El Salvador; and MiBanco in Peru.

2 This document was written for USAID's Microenterprise Best Practices project by Mayada Baydas, Douglas Graham and Liza Valenzuela. It can be downloaded from the **www.mip.org** web page.

This document will explore seven questions:

¤ Why are commercial banks and finance companies entering the microfinance market?
¤ What products do they offer and how?

¤ What issues do they face and how do they resolve them?

¤ What innovations are they bringing to the microfinance field?

¤ Are they profitable?

¤ Do these banks and finance companies reach poor microentrepreneurs?

¤ What is the future of commercial bank downscaling in Latin America?

Why Are Commercial Banks and Finance Companies Entering the Microfinance Market?[3]

The simple answer appears to be competition. Latin American countries have experienced a decade or two of macro economic stabilization efforts which have had three important effects:

a reduction in the role of the state and an increase in private sector economic activity;

lower rates of inflation; and

financial sector liberalization, which has freed interest rates and reduced barriers to the entry of new banks and finance companies.

These important changes have led to an increase in the number of private banks, which most typically originated as a means to finance the activities of emerging business groups. Spanish and Chilean consumer finance banks have also entered various Latin American countries. As banking systems have become more competitive and corporate profit margins are squeezed, many banks have begun to look at new niche markets.

Why the microenterprise market? Microfinance has been publicized in various Latin American countries, and the word is out that non-governmental organizations (NGOs) are able to lend money at cost-covering interest rates and get it back, with repayment rates often higher than banks'. Most of the banks that have entered the microfinance market thus far draw on these experiences. Some bankers have visited the more stellar programs, and many have even hired personnel from the successful non-governmental programs.

3 For purposes of this brief, the term commercial banks is used to represent private corporate banks as well as finance companies.

A number of the institutions entering microfinance today have come from the consumer finance market. While this is a different market, it shares many similarities with microfinance, and the leap from one product to another is less formidable. The consumer and microenterprise markets are high volume businesses with small loans and high transaction costs. This contrasts sharply to corporate lending, with its sizable loans, lower interest rates, and lower operating costs.

COMPARISON OF LOAN PRODUCTS

	MICROFINANCE	**CONSUMER**	**MEDIUM-LARGE**
Client	individual	individual	firm
Client activity	self-employed	mostly salaried employee	enterprise
Collateral	solidarity group; co-signers, cash-flow	co-signers	fixed assets
Delinquency	lower - tracked closely	high - not tracked closely	low - not tracked closely
Loan analysis	business and household cash flow; character-based	based on salary; credit scoring and credit bureau; technology-based	business cash flow
Loan Size & Term	small, short-term	small, short to medium term	large, medium to long term
Marketing	word of mouth	media advertising	media advertising
Transaction Costs	high	high	low
Volume of Loans	high	high	low

What Products Do They Offer?

Latin American banks and finance companies entering the microenterprise credit market are by and large offering small individual loans, based on the repayment capacity of the enterprise. Loans do not required fixed asset collateral, but are usually backed up by a co-signer. Terms appear to be longer than those of NGO programs, usually closer to a year, and repayment installments are frequent, often weekly.

A number of banks are experimenting with group lending – a practice that stems directly from

NGO experiences. Group lending approaches are usually found in banks that have organized an independent structure to handle microfinance, as in the subsidiaries of the Bank of Nova Scotia in Guyana and the Banco de Desarrollo in Chile, or in those which have hired NGO staff -- as in the case of the Banco Empresarial in Guatemala and the Banco Económico in Bolivia.

Two other modalities have been observed: a bank microlending unit that lends to NGOs which then onlends through group mechanisms (Banco Wiese in Peru); and microlending through private "brokers" who organize the client groups and bring them to the bank, a modality found among three Nicaraguan banks.

Issues Bank Downscalers Face and How They Solve Them

Staffing. Experience has shown that loan officers, who have the main contact with the client and represent the bank in the client's eyes, must have strong people skills and a genuine desire and ability to work with low-income people. Since most conventional banks don't have personnel with a social services vocation, microfinance units usually recruit from the outside. Many, such as Banco Empresarial in Guatemala and Banco Económico in Bolivia, have recruited NGO staff, who bring with them a sense of social mission, a more modest salary history, and a knowledge of methodologies to reach out to a special clientele. For back-office jobs and middle-management, the story is different. A number of bankers at the Santiago conference reported recruiting staff from within their banks for these jobs.

Commitment. Without commitment at the highest levels of the bank, these incursions in microfinance do not last. Those banks whose entry is principally motivated by a desire to improve their public image or those merely responding to laws requiring them to dedicate a percentage of funds towards small business appear to have the smallest, least aggressive programs. On the other hand, those whose entry is motivated by a search for a new profitable market, regardless of whether their motives are purely economic or also social, appear to be expanding at a faster pace and with stronger financial results. While the long term interest of the banks and finance companies is not yet proven, most banks are utilizing their own deposit base for on-lending (as opposed to donor resources), and a few are making important investments in technological innovations. If sufficiently profitable over the medium term, it appears likely that many banks may stay in the market.

Administrative Structure. A critical issue is how the bank is organized to provide microfinance. Conventional corporate banking is very a different business from microfinance, and the structure necessary to support large transactions is inappropriate for the microfinance business. Conventional banks often have many departments to process and administer their loans (e.g. loan initiation, underwriting, legal, issuance, accounting, collections). Facilities are usually elegant and close to major business centers, staff are financially-minded and sophisticated, and rewards are based on placing large loans. Microfinance institutions require more simple offices, convenient for the client, staff who feel comfortable with a poorer clientele, and a simple operating structure wherein the loan officer tends to be the loan initiator as well as the collection agent. Banks that have simply opened a new microfinance window by offering a smaller sized loan, while maintaining the same corporate loan process, have found it difficult to mesh the two cultures and many have withdrawn from the market. Others have had more success by simply installing a separate, specialized organizational unit within the larger bank. The idea of using subsidiary, or in its less dramatic form a specialized microenterprise department to deal exclusively with the microentrepreneur has been a more successful organizational innovation. All systems and procedures close to the client are unique to the microfinance operation, and clients do not interact with the larger bank. In the case of two Chilean banks, a special window with a trained teller located next to the banks' other windows is used for the microenterprise client.

<u>Innovation</u>

Microfinance innovation in Latin America is clearly in the commercial banking sector. What can be observed thus far among the banks committed to microfinance is a strong emphasis on systems and technology to reduce the costs of processing thousands of tiny loans. From sketchy evidence, it appears that bank microenterprise units have operating expenses ratios similar to the strongest specialized microfinance institutions (in the 10% to 20% range). While that may sound acceptable to observers of the microenterprise development field, they are not acceptable to many microfinance bankers who still compare themselves with traditional banking industry ratios. At the USAID-sponsored bankers conference in Santiago, Chile, bankers described a variety of cost-reduction strategies, including credit cards, smart cards, credit scoring techniques, staff recruitment methods, consumer lending adaptations, and subsidiary arrangements. The outside observer is struck by this dedicated search for technique, a search reminiscent of the days when non-governmental organizations pioneered micro lending methodologies.

<u>Are They Profitable?</u>

All of the banks interviewed for the *Commercial Banks in Microfinance* report as well as those participating in the Santiago conference opined that the microfinance market is profitable. Data to confirm this is scarce, but more is becoming available. Three regulated financial institutions which emerged from non-governmental organizations (BancoSol, Caja Los Andes in Bolivia and Financiera Calpiá in El Salvador) have return on equity figures in their twenties and thirties -- higher than the returns of most corporate banks (generally in the teens). It is also common knowledge that the Unit Desas of the Bank Rakyat Indonesia have been the money makers for the larger BRI. A new study of one commercial bank in Latin America[4] also confirms strong levels of profitability for the bank's microfinance product, stronger in fact, than any other division of the bank. While anecdotal, the "mood" of the conferences is telling. In the November 1996 conference, the parting words of a Jamaican banker voiced one of its principal conclusions: "we are sitting on a gold mine. " By the second conference in Santiago, 18 months later, the

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4 Mark Wenner, "*Lessons in Commercial Bank Downscaling: The Case of Banco Empresa*," Inter-American Development Bank, 1998

sentiments of the group were best expressed by a Paraguayan banker who said: "I wouldn't want to have any of you as my competitors." From the point of view of the bankers in Santiago, profit was no longer an issue, but rather competition. Whether this high profitability and hence continued interest will persist in a time of economic crisis, as experienced in Asia, only time will tell.

Do the Banks Reach the Poor?

The *Commercial Banks in Microfinance* authors interviewed 17 bankers and derived information on average loan sizes. If we exclude the BRI, which has phenomenal numbers (2.3 million borrowers with loans outstanding of $1.42 billion), the rest of the banks had an average of 8,500 clients, an average loan size of $1,400 and a portfolio of about $10.2 million. Two banks in the sample had average loan sizes under $300, a figure that has been generally regarded as the upper limit for lending to the poorest people, and two banks had loan sizes above $3,000. The chart below presents the distribution by average loan size of the 17 banks.

AVERAGE LOAN SIZE
Banks Participating in Microfinance Conference, Nov. 1996

Average Loans under $300	2 banks
Average Loans $301 and $1,000	7 banks
Average Loans $1,001 and $2,000	4 banks
Average Loans $2001 to $3,000	2 banks
Average Loans $3,001 to $4,000	2 banks

Traditional banks will probably never be able to reach the poorest of clients, who by their condition require additional services, such as basic literacy, sanitation and health. Banks will also probably be unable to serve clients in remote rural areas which have limited economic dynamism or rural infrastructure. Unless governments solve these urgent problems though education, improved health services, rural roads, telecommunications, and improved agricultural sector policies, these clients will probably remain on the fringes of the national economy.

What is the Future of Commercial Banks in Microfinance?

Commercial banks entering the microfinance market are principally offering loans for microentrepreneurs, and not microsavings or other financial services. There are a few exceptions, mostly from outside the Latin America region: the Worker's Bank in Jamaica, the Standard Bank in South Africa, and the BRI and Bank Dagang Bali in Indonesia. As Latin American banks become more comfortable dealing with a lower-income market and as competition increases, they are likely to begin offering a diversity of products to the low-income client. Two Spanish banks (Bilbao y Vizcaya and Santander) which are heavily invested in the consumer finance market in Latin America, have amassed voluminous small savings. Observant local banks will likely follow the lead as the current consumer finance wave sweeps through Latin America.

It is likely that commercial institutions will become the dominant actors in microfinance in the Latin America region. In some countries, such as Bolivia and Chile, banks have more loans and larger volumes than all of the NGOs combined. In countries with strong credit union movements (Guatemala, Ecuador, and to a lesser extent Honduras and Bolivia), these banks will be competing head to head with credit unions for the microfinance market. NGOs which wish to compete on a larger scale will probably best do so by transforming themselves into regulated banks or finance companies. It is yet to be seen whether other countries in Latin America will institute a specialized non-banking institution license, as have Bolivia and, to some extent, Peru.

It appears donor investments in microenterprise over the years are beginning to pay off, as the field is becoming increasingly commercialized. Given that these banks are using their own resources, it is likely the role of donors will begin to change. How donors can best support the commercialization process without creating market distortions is a critical new question.

This brief was written by Liza Valenzuela, Deputy Director, Office of Microenterprise Development.

Office of Microenterprise Development, Bureau for Global Programs
U.S. Agency for International Development
Telephone: (202) 712-0030; Fax: (202) 216-3228
Home Page: **www.mip.org**